

**COMMISSION de SURVEILLANCE
du SECTEUR FINANCIER**

In case of discrepancies between the French and the English texts, the French text shall prevail.

Luxembourg, 28 March 2011

To all Luxembourg law credit institutions and
branches of non-EU credit institutions

CIRCULAR CSSF 11/507

Re: Guidelines of the European Banking Authority, EBA (formerly CEBS) concerning Chapter 2-1 of Part X (points 8-1 to 8-8) of Circular CSSF 06/273, as amended.

Ladies and Gentlemen,

This circular implements in Luxembourg legislation the new Guidelines of the EBA “CEBS guidelines to Article 122a of the Capital Requirements Directive”, which relate to Chapter 2-1 of Part X (points 8-1 to 8-8) of Circular CSSF 06/273, as amended. The EBA issued these Guidelines in order to clarify the qualitative and quantitative requirements imposed on credit institutions in the context of securitisation, more specifically the requirement of a retained net economic interest of at least 5%.

The Guidelines are appended to this circular. They are also available on the EBA's website at: <http://www.eba.europa.eu>.

These Guidelines shall be read together with Chapter 2-1 of Part X (points 8-1 to 8-8) of Circular CSSF 06/273 (as amended). They make a clear distinction between the requirements to be complied with by:

- i) credit institutions “investing” in securitisations;
- ii) credit institutions assuming “exposure” to securitisations; and
- iii) credit institutions acting as “sponsors” or “originators” of securitisations.

The document lists and explains all the paragraphs of Article 122a of Directive 2006/48/EC, as amended by Directive 2009/111/EC, which correspond to points 8-1 to 8-8 of Chapter 2-1 of Part X of Circular CSSF 06/273 (as amended).

In respect of the provisions under Chapter 2-1, the Guidelines provide some additional specifications to credit institutions acting as originators, sponsors or original lenders of securitisations regarding the retained net economic interest of at least 5%.

Particular attention should be paid to the fact that points 27 and 43 of the Guidelines provide specific clarifications regarding the maintenance of the level of retention. These points specify that the net economic interest is measured at origination and must be maintained on an ongoing basis, but that the level of retention may be reduced throughout the life of a securitisation and that a dynamic re-adjustment of the retained percentage throughout the life of the securitisation is not necessarily required.

The above-mentioned document explains that sanctions apply in case of non-compliance with the provisions of Chapter 2-1. Thus, points 101 to 112 of the document lay down the methods for the calculation of proportionate additional risk weights which would apply to the relevant securitisation positions in case of omission or negligence of the credit institution. Point 111 of the document clarifies that a credit institution investing in a securitisation will not be subject to the application of additional risk weights in case of omission or negligence of the originator, sponsor or original lender credit institution concerning the level of retention, provided that the former fulfilled its requirements,

demonstrating its good will, to obtain the necessary information from the credit institution acting as originator, sponsor or original lender.

These Guidelines apply with immediate effect to new securitisations issued as from 1 January 2011. However, they will only apply as from 1 January 2015 to existing securitisations where underlying exposures are added or substituted by new exposures after that date.

Credit institutions must inform the CSSF of any new investment in a securitisation. Furthermore, it should be borne in mind that, according to the provisions of point 4 of Section 8 of Circular CSSF 10/496, before acting as originators, sponsors or original lenders, credit institutions must provide the CSSF with relevant data allowing the verification of compliance with the provisions of Chapter 2-1 of Part X of Circular CSSF 06/273 (as amended).

Among others, before acting as originators and sponsors, credit institutions must demonstrate that they apply the same sound and well-defined criteria for credit-granting in accordance with points 6 to 8 of Part XVII of Circular CSSF 06/273 (as amended) to exposures to be securitised as they apply to exposures to be held on their book. To this end, they must demonstrate that they apply the same processes for approving and, where relevant, amending, renewing and re-financing credits. Credit institutions must also demonstrate that they apply the same standards of analysis to participations or underwritings in securitisation issues purchased from third parties whether such participations or underwritings are to be held on their trading or non-trading book.

Credit institutions must also demonstrate that they disclose to investors the level of their commitment under point 8-1 of Chapter 2-1 of Part X of Circular CSSF 06/273 (as amended) to maintain a net economic interest of at least 5% in the securitisation. Thus, they must demonstrate that they ensure that prospective investors have readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation transaction as

well as such information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures. For that purpose, materially relevant data shall be determined as at the date of the securitisation and where appropriate due to the nature of the securitisation thereafter.

This circular enters into force with immediate effect.

Yours faithfully,

COMMISSION DE SURVEILLANCE DU SECTEUR FINANCIER

Claude SIMON
Director

Andrée BILLON
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Annex:

- *CEBS guidelines to Article 122a of the Capital Requirements Directive*



31 December 2010

Guidelines to Article 122a of the Capital Requirements Directive

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Background

The amendments to the Capital Requirements Directive¹ by Directive 2009/111/EC (“CRD 2”) relating to securitisations – exposures to transferred credit risk – request the Committee of European Banking Supervisors (CEBS) to elaborate guidelines for the convergence of supervisory practices with regard to Article 122a, including the measures taken in case of breach of the due diligence and risk management requirements.

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

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

These guidelines seek to provide some general considerations on the application of Article 122a and then go on to provide clarity on specific aspects of the detailed requirements. These guidelines are organised paragraph by paragraph, following the order of the Directive text.

Objectives and methodology

The objectives of the guidelines are to:

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

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

CEBS received numerous comments on various technical matters from individual stakeholders during the preparation of these guidelines.

¹ Capital Requirements Directive (CRD) is a technical expression which comprises Directive 2006/48/EC and Directive 2006/49/EC. Please note that, in general, references to “Directive 2006/48/EC” and “Directive 2006/49/EC” or the “CRD” refer to the amended versions of the Directives and references in these Guidelines to a particular Article of the CRD refer to the amended Directives. The amending Directive (Directive 2009/111/EC) was published on 17 November 2009 and can be found under: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF>. The Commission has also published a consolidated version of Directive 2006/48/EC; this includes the text of Article 122a, but excludes the Recitals discussed in this guidance.

Implementation date

CEBS expects its Members to adopt the guidelines into their national supervisory framework and apply them from 1 January 2011, i.e. together with the new Directive provisions.

Considerations on Recitals 24-27

Recital 24

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

Recital 25

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

Recital 26

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

requirement should be proposed, and whether the methods of calculating the retention requirement deliver the objective of a better alignment of the interests of the originators or sponsors and the investors.

Recital 27

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

General considerations

1. Recitals² 24 to 27 set out key principles which credit institutions should consider when assessing compliance with the requirements of Article 122a.
 - (i). Credit institutions should consider whether the overall objective of Article 122a has been met, i.e. that any misalignment between the interests of originators or sponsors and investors has been removed.
 - (ii). Credit institutions should consider whether the securitisation transaction has been structured in such a way as to avoid or undermine the application of the retention requirement, in particular through any fee structure, premium structure, or other profit extraction mechanism.
 - (iii). Credit institutions should consider the economic substance of the entire transaction when assessing whether the retention meets the requirements set out in Article 122a. For example, as securitisations may be structured in many different ways, the retention requirement should be applicable in all situations where the economic substance of the securitisation meets the definition of Directive 2006/48/EC, whatever the legal structure of the transaction.
2. Further clarification on the application of Article 122a to purchased receivables is provided under clause 59 below.
3. Where in Recital 25 it is stated that “purchased receivables should not be subject to the retention requirement if they arise from corporate activity where they are transferred or sold at a discount to finance such activity”, this is to be read as an exemption in the narrower sense for very specific types of activity (e.g. factoring) and not as an exemption in the broader sense for transactions that fall under the definition of securitisation (for instance, it is not an exemption for all asset-backed commercial paper programmes, or “ABCP conduits”).

² The analysed Recitals 24-27 are from Directive 2009/111/EC, and have not been included in the consolidated 2006/48/EC.

Considerations on Paragraphs 1-7

General considerations

4. As a general principle, for transactions which meet the definition of a securitisation under Article 4(36) of Directive 2006/48/EC (for instance, due to the tranching of credit risk), the provisions of Article 122a would typically apply.
5. The text of Article 122a makes a distinction between the requirements that are expected of:
 - (i). credit institutions “investing” in securitisations;
 - (ii). credit institutions assuming “exposure” to securitisations; and
 - (iii). credit institutions acting as “sponsors” or “originators” of securitisations or securitised exposures.
6. Paragraphs 1, 4 and 5 are framed around credit institutions investing in, or assuming exposure to, securitisations. In this respect, whether or not significant risk transfer is met under CRD by an originating credit institution is not pertinent.
7. Article 122a contains sanctions for non-compliance which are detailed under Paragraphs 5 and 6. It should be noted that the requirements in Paragraph 5 reference the requirements set out in Paragraphs 4, 5 and 7, with the requirements of Paragraph 4 in turn referencing the requirements of Paragraph 1.

Group requirements

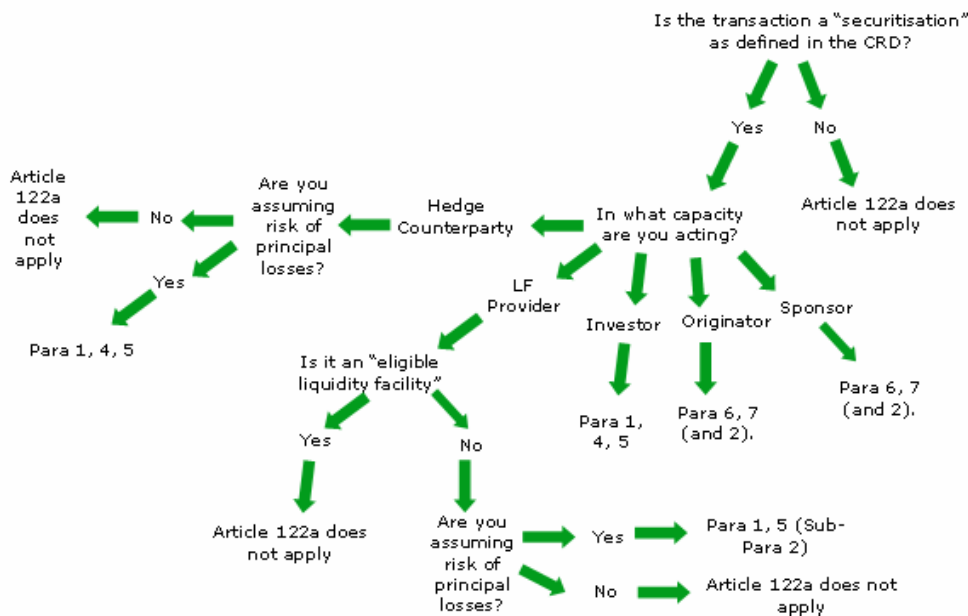
8. In addition to its own activities, a credit institution will also become exposed to credit risk of a securitisation position by virtue of the relevant activities of any related entity (authorised or unauthorised), which falls within the same scope of a group where consolidated supervision is applied. Paragraph 1, therefore, requires that such exposure to the credit risk of a securitisation position (whether in the trading book or non-trading book) shall only be assumed if the requirements of Article 122a are met. However, in determining the measures necessary for compliance with such requirements, when the exposure occurs within the trading book of another group entity, the credit institution may also take into account Paragraphs 4 and 5 and the guidance provided thereon. Competent authorities may do likewise in judging the materiality of any infringements.
9. The guidance on Paragraphs 4 and 5 (as referenced above) provides flexibility in dealing with limited circumstances where any such exposures or positions in the trading book are not overly material, nor form a disproportionate share of trading activities, provided that there is a thorough understanding of the exposures or positions, and that formal policies and procedures have been implemented which are appropriate and commensurate with that entity's and the group's overall risk profile. In such circumstances, the application of any additional risk weights for infringements (under Paragraph 5), due to non-fulfilment of the retention requirements (under Paragraph 1), would only apply for such exposures or positions where

these conditions are deemed not to be met. Competent authorities will be required to assess such instances of non-fulfilment as part of their on-going supervision. As Paragraph 9 already requires competent authorities to report annually on compliance with Article 122a, how EU banking groups are using any limited market-making function for non- or partially compliant securitisations (e.g. in their non-EU authorised entities, which do not themselves otherwise fall directly within the scope of the provisions of Article 122a), and the extent to which the requirements of Article 122a are, indeed, being respected at group level, will be monitored as part of this annual post-implementation review.

- The requirement that net economic interest be retained on an ongoing basis (i.e. no hedges, short positions or sales) also applies at both group consolidated and solo level.

Roles assumed by a credit institution in a securitisation

- For the purposes of clarity, the simplified diagram and table below outline the various roles a credit institution can assume with respect to a securitisation, and how these can be mapped to the application of sanctions for non-compliance. However, see clauses 12-16 below for further elaboration.



	Para 1 (All)	Para 4 (All)	Para 5 (Sub-Para 1)	Para 5 (Sub-Para 2)	Para 6 (All)	Para 7 (All)
Summary requirement:	Confirm retention	Analyse, understand, stress-test	Monitor	Understand structural features	Same criteria for securitised and retained exposures	Provide sufficient disclosure and information
Applies to:	Credit institution assuming "exposure" to credit risk (including when "investing")	Credit institution when "investing" only	Credit institution when "investing" only	Credit institution assuming "exposure" to credit risk (including when "investing")	Credit institution as "sponsor" or "originator"	Credit institution as "sponsor" or "originator"
Additional guidance:		Does not apply if assuming "exposure" to credit risk, but not "investing"	Does not apply if assuming "exposure" to credit risk, but not "investing"			
Would typically apply to credit institutions in role as:	Investor; non-eligible liquidity facility provider that assumes risk arising from principal losses; derivative/hedge counterparty assuming risk arising from principal losses	Investor; derivative/hedge counterparty assuming risk arising from principal losses	Investor; derivative/hedge counterparty assuming risk arising from principal losses	Investor; non-eligible liquidity facility provider that assumes risk arising from principal losses; derivative/hedge counterparty assuming risk arising from principal losses	Sponsor, originator	Sponsor, originator
Would typically not apply to credit institutions in role as:	Derivative/hedge counterparty not assuming risk arising from principal losses; eligible liquidity facility provider; non-eligible liquidity facility provider not assuming risk arising from principal losses	All eligible and non-eligible liquidity facility providers; derivative/hedge counterparty not assuming risk arising from principal losses	All eligible and non-eligible liquidity facility providers; derivative/hedge counterparty not assuming risk arising from principal losses	Derivative/hedge counterparty not assuming risk arising from principal losses; eligible liquidity facility provider; non-eligible liquidity facility provider not assuming risk arising from principal losses	All other roles	All other roles
Do additional risk weights apply if breach of requirements?	Yes, see clause 18 below	Yes	Yes	Yes	No, specific sanctions within Para 6 apply instead (inclusion of securitised exposures in capital calculation)	Yes, additional risk weights are applied to the interest retained by the sponsor or originator

12. With respect to liquidity facilities provided by credit institutions to securitisations, a key element of deciding whether the credit institution should be subject to Article 122a is whether the credit institution as liquidity facility provider is exposed to the credit risk of the securitisation position(s). The CRD provides for preferential treatment for certain types of liquidity facilities ranking “super senior” to all other securitisation exposures, in that they meet specific requirements (set out in Annex IX, part 4, paragraph 2.4.1 point 13) aimed at ensuring that they are not exposed to the risk of default of the underlying exposures (eligible liquidity facilities). Liquidity facilities provided by credit institutions that are not eligible under the above mentioned criteria should be subject to the specific requirements of Article 122a that are indicated in the table above. However, under exceptional circumstances, if the facility provider can demonstrate with robust evidence that the liquidity facilities are not assuming exposure to credit risk arising from principal losses on the securitised exposures or securitisation position(s), such non-eligible liquidity facilities would not be subject to the requirements of Article 122a.
13. With respect to credit institutions acting as derivative/hedge counterparties to securitisations, once again a key element of deciding whether the credit institution should be subject to Article 122a is whether the credit institution as derivative/hedge counterparty is exposed to the risk arising from principal losses on the securitised exposures or securitisation position(s). Consequently, in the table above a distinction is made between a derivative/hedge counterparty assuming risk arising from principal losses (which should typically be subject to the requirements of Article 122a), and a derivative/hedge counterparty not assuming risk arising from principal losses (which should typically not be subject to the requirements of Article 122a). The former would include, for instance, a credit institution providing a total return swap that covers the credit risk of the securitised exposures, and hence provides credit enhancement to the securitisation. The latter would include, for instance, a credit institution providing an interest rate or currency swap to a securitisation that does not assume the credit risk of the securitised exposures (for instance, by only referencing performing receivables in its notional). Credit institutions should determine the extent to which a role as derivative/hedge counterparty to a securitisation does or does not assume credit risk, and, thereafter, apply the specific requirements and paragraphs of Article 122a that are indicated in the table above.
14. Aside from liquidity facility providers and derivative/hedge counterparties, where exposure to a securitisation is assumed by a credit institution in one of the other forms outlined below (i.e. for the purpose of fulfilling one of the retention options (a)-(d) in Paragraph 1), such exposure could be deemed as being subject to Article 122a, even if not explicitly referenced in the table above. For instance, providing a letter of credit to an ABCP conduit would be captured under Article 122a. On the other hand, there may be other circumstances in which a credit institution deems that it is neither investing nor assuming exposure to a securitisation (for instance, in certain types of repo transaction or in securities lending), but it is not within the scope of this guidance to address all such circumstances.

15. To the extent that a credit institution acting as liquidity facility provider, hedge counterparty, letter of credit provider or similar is treated as subject to the requirements of Article 122a by reason of assuming exposure to a securitisation vehicle with multiple discrete underlying transactions, positions or exposures (for instance, where there are multiple sellers in an ABCP conduit), and assuming such securitisation vehicle is structured to separate the credit risk of one underlying transaction from another, the retention requirement should be applied only to those transactions, positions or exposures to which the credit institution acting in such role has exposure, and not to those to which it has not assumed exposure.
16. In circumstances where a credit institution is assuming credit risk with respect to a securitisation in multiple capacities (i.e. more than one of investor, liquidity facility provider, hedge counterparty, etc), such credit institution should ensure that it is meeting whatever provisions apply to each relevant role (as outlined above). In circumstances where a credit institution is both assuming credit risk with respect to a securitisation (for instance, as investor, liquidity facility provider, hedge counterparty, etc), but is also sponsor or originator of such securitisation (and hence involved in securitising the relevant exposures), once again, it must ensure that it is meeting whatever provisions apply to each relevant role that it assumes.

Other issues

17. With respect to warehousing transactions, or transactions in which there is a ramp-up period (in which exposures are accumulated) before securitising, the applicability of Article 122a to these depends upon whether the transactions themselves (and more specifically, the transactions during their warehousing or ramp-up periods) would fall under the definition of a securitisation. If the definition of a securitisation is not met, they would be out of the scope of Article 122a. If the definition of a securitisation is met, then the requirements of Article 122a would be applicable.
18. With respect to the application of additional risk weights for non-compliance with Paragraph 1 in the table above, although breach of Paragraph 1 is not directly referenced as causing additional risk weights to be applied in Paragraph 5, because demonstrating policies and procedures for analysing and recording the information required under Paragraph 1 is referenced as a requirement of fulfilling Paragraph 4, and because non-fulfilment of Paragraph 4 leads to additional risk weights under Paragraph 5, then non-fulfilment of the requirements of Paragraph 1 would typically lead to the application of additional risk weights under Paragraph 5.³
19. With respect to the application of additional risk weights for non-compliance with Paragraph 7 in the table above, the following should be noted. First, failure to meet the requirements of Paragraph 7 is explicitly mentioned in Paragraph 5 as being grounds for a competent authority to impose additional risk weights. However, in all other cases such additional risk weights are applied to credit institutions in their capacity as investors in, or otherwise

³ The additional risk weights are contained in Paragraph 5 (sub-paragraph 3), and consequently the fact that Paragraph 4 (when viewed in isolation) only applies to credit institutions when “investing” (as opposed to, more broadly, when “assuming exposure”) does not prevent the application of additional risk weights for non-fulfilment of the requirements of Paragraph 1.

assuming exposure to, securitisations; it is only in Paragraph 7 that additional risk weights are applied to credit institutions in their capacity as sponsors or originators. As such, it is intended that such additional risk weights for non-compliance be applied to the originator's or sponsor's retained position in, or other exposure to, such non-compliant securitisations, while taking into account that, in these particular circumstances, additional risk weights may not necessarily be appropriate (i.e. there may not be "negligence or omission", as specified in Paragraph 5), and the imposition of additional risk weights should be dependent upon circumstances and supervisory judgement. It is also intended that such additional risk weights would be applied to credit institutions as originators and sponsors in the same manner as those that apply to credit institutions when investing or assuming exposure, i.e. the framework elaborated under Paragraph 5 below.

20. Use of the term "due diligence" within Article 122a, and by extension use of the term within this guidance, is not to be understood in the narrow sense in which it may be used for audit or legal purposes. Rather, it is to be understood to encompass credit analysis, risk management, and similar activities of the type described in Paragraphs 4 and 5 of Article 122a, for instance.

Paragraph 1

Paragraph 1

A credit institution, other than when acting as an originator, a sponsor or original lender, shall be exposed to the credit risk of a securitisation position in its trading book or non-trading book only if the originator, sponsor or original lender has explicitly disclosed to the credit institution that it will retain, on an ongoing basis, a material net economic interest which, in any event, shall not be less than 5 %.

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

- a) retention of no less than 5 % of the nominal value of each of the tranches sold or transferred to the investors;*
- b) in the case of securitisations of revolving exposures, retention of the originator’s interest of no less than 5 % of the nominal value of the securitised exposures;*
- c) retention of randomly selected exposures, equivalent to no less than 5 % of the nominal amount of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is no less than 100 at origination; or*
- d) retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total no less than 5 % of the nominal value of the securitised exposures.*

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

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

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

General considerations

21. For an overview of how the provisions of Paragraph 1 apply with respect to the various roles a credit institution can assume in a securitisation, and how these, in turn, can be mapped to the application of sanctions for non-compliance with the provisions of Paragraph 1, see the section “Considerations on Paragraphs 1-7” above.
22. As noted in clause 4 above, transactions that meet the Directive definition of a securitisation in Article 4(36) would be subject to Article 122a. This definition captures the tranching of credit risk, rather than specifying the

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

Definition of originator, sponsor and original lender

23. The Directive recognises that different entities may fulfil the obligation to retain, and permits an “originator, sponsor or original lender” to meet the requirement. While the terms originator and sponsor have been defined by the Directive⁵, the term original lender remains undefined. The original lender and the originator will typically be the same entity; however this may not always be the case. For example, textual constraints in how the term “originator” is defined specifically in Directive 2006/48/EC, Article 4 (41) – on which, see below – might make such definition inapplicable to certain lenders, which might then be viewed as “original lenders” rather than “originators”.

24. For ease of reference:

- (i). Directive 2006/48/EC, Article 4 (41) defines an “originator” as either of the following:
 - a) an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or
 - b) an entity which purchases a third party's exposures onto its balance sheet and then securitises them.
- (ii). Directive 2006/48/EC, Article 4 (42) defines a “sponsor” as a credit institution other than an originator credit institution that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities.

25. It should be noted that, for the purposes of the Directive, Article 4 (42) provides that a sponsor must be a credit institution. Therefore, when the

⁴ Such transactions are captured by Article 122a due to the definition of a securitisation. However, alignment of interest is automatically met in issuing such securities – not because the originator, sponsor or original lender has not achieved significant risk transfer under CRD, but instead because the credit risk of the underlying assets is not transferred to investors. To give just one example, if a securitisation had as underlying collateral the covered bonds of a number of credit institutions, this could fall under the definition of a securitisation, but alignment of interest would be automatically met, as such covered bonds might not transfer the credit risk of the underlying assets to investors in such securities at their time of issuance.

⁵ 2006/48/EC

entity which acts as the sponsor of a securitisation is not a credit institution, the retention requirement must be fulfilled instead through either the originator or the original lender. However, in certain limited circumstances in which it is simply not possible to identify any party to a transaction that fits any of the roles of “original lender”, “originator”, or “sponsor”, as defined in the Directive, then the following should be considered. First, it should be ensured that the transaction fulfils the definition of a securitisation, as it is possible that the inability to identify an “originator”, “original lender” or “sponsor” of the transaction could be a result of the transaction not fulfilling such definition. However, should it be confirmed that the transaction is (by definition) a securitisation, it should be ensured that there is retention by whatever party would most appropriately fulfil this role outside of the specific constraints of these definitions, while taking account of the fact that the intent of the provisions of Article 122a is to align the interests of investors with those of originators, sponsors and original lenders. In the absence of any definable originator, sponsor or original lender, the intent should be to align the interests of investors with those of that party to the transaction that is transferring a proportion of the risks and rewards of the underlying exposures or positions to investors.

26. There are circumstances in which there are entities that do indeed meet the definition of originator or sponsor, or fulfil the role of original lender; however, another entity that neither meets the definition of sponsor or originator, nor fulfils the role of original lender – but whose interests are most optimally aligned with those of investors – seeks instead to fulfil the retention requirement. Two (non-exhaustive) examples include the asset manager of a securitisation where there is ongoing management and substitution of exposures (where such asset manager is not a credit institution), or the most subordinated investor in a securitisation where such investor was also involved in structuring the transaction and selecting the exposures to be securitised (but is by definition neither the originator nor the sponsor, and nor is it the original lender). CEBS is aware that it is possible that such an entity could fulfil the retention requirement by means of an SPV that is established to act as “originator” (for instance, by purchasing the exposures to be securitised), with such an SPV consequently meeting the definition of the term “originator” under the Directive, but which then, in turn, has its retained credit risk assumed by (and potentially also its funding provided by) that entity that neither meets the definition of originator or sponsor nor fulfils the role of original lender. Where such arrangements are entered into, the primary consideration should be that retention is ultimately met by an entity with which alignment of interest is optimally achieved, and that this is not a mechanism for re-distributing the technically “retained” exposure to other investors.

To provide two specific examples, where the retained interest of such an “originator” SPV was ultimately held by the asset manager of a collateralised loan obligation (hereafter “CLO”), or by a subordinated investor involved in the selection of exposures and the structuring of tranches in a commercial mortgage backed security (hereafter “CMBS”), these examples are both uses of an intermediate SPV that could ultimately ensure alignment of interest (when its retained interest is funded and credit risk is assumed by one of the above parties). However, where the retained interest of such an “originator” SPV is sold on to other third-party investors with no involvement in the

relevant securitisation, or to other funds managed by the asset manager that structured the relevant securitisation, this does not ensure alignment of interest. While it is not possible to cover all potential circumstances, this provides broad guidance for viewing such arrangements that meet the definition of “originator” via the potential use of an SPV, but which must, nonetheless, ultimately ensure alignment of interest.

Specific issues in ensuring appropriate retention

27. The level of commitment by originators, sponsors or original lenders must not be reduced either through hedging or selling the retained interest. However, the level of commitment will not be deemed to have been affected by either the amortisation of such interest via cash flow allocation (within parameters further outlined below) or through the allocation of losses, which, in effect, reduce the level of retention over time (within parameters further outlined below).
28. At origination there should not be any embedded mechanism in the securitisation structure by which the minimum retention requirement of an originator, sponsor or original lender would necessarily decline over time materially faster than the interest transferred such that this would cause the retention requirement to subsequently be breached (this principle is explored in more detail under 43 below).
29. In circumstances where the securitised exposures are those of multiple originators or original lenders, then retention of net economic interest must be fulfilled by each original lender or originator with reference to the proportion of total securitised exposures in the securitisation for which it is the originator or original lender or, alternatively, can be fulfilled by the sponsor of the securitisation into which such securitised exposures of multiple originators or multiple original lenders have been sold or otherwise pooled. For the avoidance of doubt, this means that fulfilling the requirement for retention of net economic interest cannot be undertaken by one originator or original lender retaining a net economic interest while none of the other multiple originators or original lenders retain any net economic interest, unless such originator or original lender is also the sponsor of the securitisation and fulfils the requirement thus. In cases where similar circumstances could arise with respect to sponsorship of a securitisation (i.e. should there be the possibility of multiple sponsors of a securitisation), and where the retention requirement is being fulfilled by the sponsor(s) (as opposed to the originator(s) or original lender(s)), then similar guidance with respect to fulfilment of the retention requirement on an individual basis by such sponsors would apply.

For fulfilment of the requirement where multiple originators or original lenders are included in the scope of supervision on a consolidated basis, see guidance under Paragraph 2. The 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.

30. The obligation of a credit institution when assuming exposure to the credit risk of a securitisation position is to ensure that the originator, sponsor or original lender has “explicitly disclosed” that it will fulfil its retention obligation. The investing credit institution has still fulfilled its obligation should such originator, sponsor or original lender fail to act in the manner it disclosed (for instance, by not retaining such an interest, or due to unforeseen corporate actions and events, contrary to what it previously communicated) and the credit institution is not deemed to have been responsible for negligence or omission in the fulfilment of its due diligence obligations.
31. In the case set out in the above clause, the credit institution is not obliged to dispose of such a securitisation position, and neither will such credit institution typically be subject to an additional risk weight for any such securitisation position for which the retention requirement is not met, if this is not due to any negligence or omission on the part of such credit institution. Breaches in the commitment to retain, or in other requirements for which there is reliance upon originators, sponsors or original lenders, will neither result in any additional risk weights to the investing credit institutions nor the compulsion to sell the relevant securitisation positions, if the probability of such breaches has been adequately taken into account in the due diligence process (for example, the credit institution has properly considered the nature of the commitment to maintain the net economic interest and to disclose relevant data on the underlying exposures, such as via any contractual provisions). However, any prior breaches in the undertaking to retain for previous securitisations by the same sponsor, originator or original lender should be assessed appropriately by an investing credit institution, or may lead to additional risk weights for such investing credit institution.
32. The form of retention (i.e. which of options (a) through (d) is used) cannot change during the life of the securitisation, without such change impacting the fulfilment of the requirements of Paragraph 1, except under exceptional circumstances (for example, when re-structuring of a transaction is necessary), provided that such change is explicable and has good reason⁶, and provided that such change is disclosed in a transparent manner to investors (on which, see guidance to Paragraph 7 below, and, in particular, clause 123). Credit institutions should be sensitive to potential abuse by originators, sponsors or original lenders of such ability to change the form of retention.

⁶ A sponsor, originator or original lender seeking to adjust or reduce its retained interest in order to protect itself against a changing credit outlook with respect to the underlying exposures would not be considered a good reason for changing the form of retention.

Defining the retained “net economic interest”

33. Where the percentage of retention is referenced to the nominal value of the securitised exposures in Paragraph 1, this refers to the gross exposure value (i.e. gross of impairments and value adjustments, not net of these).
34. In the various retention options outlined in Paragraph 1, there are references to “nominal value” in (a), (b) and (d), and “nominal amount” in (c). This distinction is not considered to be intentional, and need not be considered when measuring the retained interest provided elsewhere in this document.
35. The Directive defines “net economic interest” as a nominal exposure, and not a notional exposure. Therefore, securitisation positions which have no principal component (for example, an excess spread tranche) do not qualify as part of the retention requirement.
36. Retention of a net economic interest under Paragraph 1 can be fulfilled by any one of options (a), (b), (c) or (d) separately, but not by a combination of more than one of these options.⁷ Similarly, retention of net economic interest under Paragraph 1 can be fulfilled by any one of the originator, sponsor or original lender, and not by a combination of these. For circumstances in which there are multiple originators or original lenders, see clauses 61-63.

Disclosing the retained interest

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

⁷ While the current text of Article 122a cannot be interpreted as allowing combinations of options (a) through (d), as part of its post-implementation review under Paragraphs 9-10, CEBS, in conjunction with competent authorities, may assess the benefits of allowing such combinations, and, if appropriate, make recommendations to the Commission for amending the Directive accordingly, given that if all retention options are feasible in the alignment of interests, any combination of such options could potentially be equally feasible.

Hedging and sale of the retained interest

38. The retention requirement should not be subject to any credit risk mitigation, any short position or any other hedge. Within the limits of what is practicable, material and could reasonably be expected to be within the control or knowledge of a credit institution, such credit institution should consider the economic substance of the transaction as a whole and consider whether any credit risk mitigation, short position or hedge essentially renders the retention ineffective.
39. Notwithstanding this, the ability of certain types of hedging to undermine the application of the retention requirement, but for others not to, is recognised. The aim is to disallow hedging that eliminates a sponsor's, originator's or original lender's exposure to the credit quality of the specific exposures that have been securitised and to seek to balance this objective with another, of ensuring that sponsors, originators and original lenders still have sufficient flexibility to risk-manage their exposure to broader changes in the credit quality of the asset classes, collateral, or macroeconomic variables to which they are exposed via their lending activities, securitisation activities, or otherwise.
40. Given the above considerations, the following types of hedge are not deemed to be permissible:
- a) A hedge on the credit risk of the securitisation positions that are retained specifically to fulfil the retention requirement is not permissible. For example, when the retention requirement is fulfilled using options (a), (b) or (d), the sponsor, originator or original lender should not buy protection on the retained position through a credit default swap.
 - b) A hedge on the credit risk of exposures that specifically fulfil the retention requirement is not permissible. For example, when the retention requirement is fulfilled using option (c), the sponsor, originator or original lender should not hedge the credit risk of the randomly selected exposures that it has retained.
41. When a sponsor, originator or original lender acts as a hedge counterparty to a securitisation (for instance, in hedging interest rate risk or currency risk), this is permissible, and is not intended to be captured under the term "any other hedge". For example, the originator, sponsor or original lender may act as counterparty to a securitisation in providing an interest rate hedge without being deemed to have "hedged" its exposure to such securitisation.
42. In securitisations of trade receivables, originators sometimes purchase external credit insurance as part of the normal operating business. Similarly, mortgage guarantee insurance is sometimes taken out in respect of a pool of mortgage loans. Such types of insurance need not necessarily be considered to be "hedges" of the underlying exposures, if undertaken as a legitimate and prudent element of credit-granting, and if their usage does not create a specific differentiation between the credit risk of (or the alignment of interest between) the retained positions or exposures and those positions or exposures that are sold to investors. For instance, mortgage guarantee insurance need not be considered a "hedge" when loans in the pool of mortgages securitised – and to which both the originator and investors are equally exposed – benefit from such insurance. However, it could be

considered a hedge if the securitised exposures do not benefit from mortgage guarantee insurance, but the exposures retained on balance sheet under option (c) do benefit from mortgage guarantee insurance. Similar considerations should apply to other forms of guarantee or insurance from which the exposures or positions of a securitisation may benefit.

Measuring the retained interest

43. The retention requirement is measured at “origination” and “shall be maintained on an ongoing basis”. Most typically, when the bonds or other liabilities of the securitisation are issued or subsequently purchased in the secondary market by an investor, the investor must, at that point in time, ensure that the originator, sponsor or original lender has explicitly disclosed that it will retain a position that meets the requirements.⁸ Furthermore, measurement of retention “at origination” can typically be interpreted as being when the exposures were first securitised, and not when the exposures were first created (for instance, not when the underlying loans were first extended). Furthermore, measurement of retention “at origination” means that 5% is the retention percentage that is required at the point in time when such retention level was measured and the requirement fulfilled (for instance, when the exposures were first securitised); dynamic re-measurement and re-adjustment of the retained percentage throughout the life of the transaction is not necessarily required (though in certain circumstances, outlined immediately below, such re-measurement and/or re-adjustment of the retained interest may be necessary from a practical perspective). However, consideration should be given to dynamics within individual transactions that may undermine the effectiveness of the retention requirement. For clarification, the following are examples of considerations with respect to payment rates, losses, revolving securitisations, and structural features of securitisations.

- (i). Payment rates: Where an originator, sponsor or original lender meets the retention requirement through option (c), due to the random nature of the selection process, the expected payment rate (“pay down” or “amortisation”) of the exposures retained on balance sheet should typically not be significantly different to the expected payment rate of the exposures in the securitisation. Therefore, any subsequent divergence from the initial retention percentage of 5% will not typically result in a failure to meet the retention requirement provided any higher payment rate of the exposures retained on balance sheet compared to the securitised exposures is not explicitly due to actions undertaken by the originator or due to non-randomness in the selection process.
- (ii). Losses: An originator, sponsor or original lender is not required to constantly replenish or readjust its retained interest to at least 5% as losses are realised on its exposures or allocated to its retained position in such securitisation. The 5% is calculated based on the nominal value of the securitised exposures at origination, and is not affected by the allocation of losses, which, in effect, reduce the level of retention over

⁸ As a corollary to the above, calculation of the retention requirement is independent of the acquisition price of the exposures to be securitised; for instance, acquiring assets at a discount to nominal value does not in itself impact calculation of the retention requirement.

time, as long as the net economic interest is not hedged or sold. This principle applies regardless of whether retention is met under options (a), (b), (c), or (d).

- (iii). Revolving securitisations: The application of the retention requirement is most clear for discrete (“stand-alone”), non-revolving (“static”) securitisations; however, many securitisations involve pools of exposures that fluctuate over time, and, therefore, by extension the retention requirement could fluctuate over time, potentially complicating calculation of, or undermining the effectiveness of, the retention requirement. For example, a pool of exposures may revolve over time (i.e. both increasing and decreasing), may have a “ramp-up period” (i.e. increase over time, before subsequently decreasing), have a “substitution period” (i.e. stay constant for a period, before decreasing), or may simply decrease over time from the outset of the securitisation (i.e. a “static” transaction). To take account of these different circumstances, where the nominal value of exposures in a securitisation may increase or decrease over time, the retained net economic interest would typically be expected to increase should the nominal value of exposures increase, but could conversely decrease proportionately should the nominal value of exposures decrease (but also due to those factors outlined in (ii) immediately above).
- (iv). Structural features of securitisations: With respect to options (a), (b) and (d), there can be priorities of payment (“waterfalls”), triggers or other mechanisms in securitisations that accelerate or decelerate the relative speed of repayment of the originator’s, sponsor’s, original lender’s and investors’ interests; for instance, repaying certain positions more rapidly via a “turbo” mechanism, or repaying certain positions more slowly and others more rapidly via early amortisation provisions. These waterfalls, triggers and other mechanisms may cause additional complexity in ascertaining if the retention requirement is being met, and can also create circumstances in which an originator, sponsor or original lender has met the retention requirement upon the “closing” of a securitisation (i.e. at time of origination), but due to cash flow allocation thereafter this may differ over the life of the securitisation.

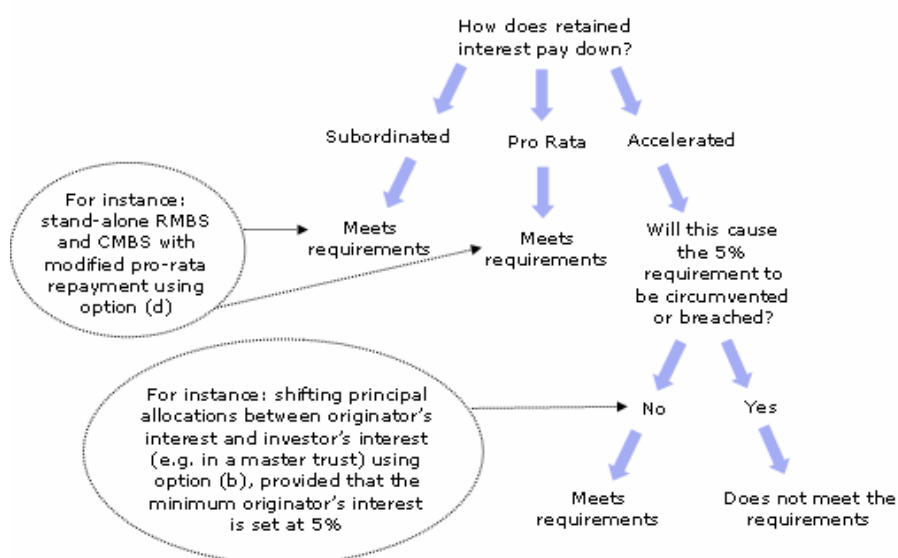
As an overall principle, when assessing such waterfalls, triggers or other mechanisms in the light of the retention requirement, the general approach should be that the originator’s, sponsor’s or original lender’s retained interest should not be prioritised in terms of cash flows (either principal flows or interest flows) to preferentially benefit from being repaid or amortising earlier in a manner that would reduce it below 5% of the then current nominal amount of the tranches sold or exposures securitised (although it could fall below 5% of the initial nominal amount of the tranches sold or exposures securitised), and so the credit support provided to the investing credit institution initially should not decline disproportionately relative to the rate of repayment on the underlying exposures.

- a) One interpretation of this would be that principal and interest flows can be used to allow the retained interest to pay down on a time-subordinated basis after, or on a pro rata basis alongside, the investor interest, but not on an accelerated

basis ahead of the investor interest such that this would cause the retention requirement to subsequently be breached. As a representative numerical example, if the retained interest is in the form of a first loss tranche under option (d), as the pool of underlying exposures declines from €100 to €50, such first loss tranche could also fall from €5 to €2.5 due to pro rata allocation of principal repayments on the underlying exposures to both investors and the originator, and this first loss tranche would consequently not have to remain at its initial level of €5. However, such first loss tranche could not, under these circumstances, benefit from accelerated repayment to decline, for instance, to €2 over the same horizon.

- b) With respect to option (d), notwithstanding the phrase “not maturing any earlier than those transferred or sold to investors”, this means that such first loss tranche can be repaid alongside other (potentially more senior) tranches on a pro-rata basis (subject to the conditions specified under (a) above), and that the first loss tranche does not “mature” any earlier does not signify that it cannot be repaid simultaneously with such other tranches.

For an illustrative example, see also the diagram below.



44. The retention requirement, as applied under option (a), references the “tranches” of the securitisation; the retention requirement, as applied under options (b), (c) and (d), references the “securitised exposures” (or potentially securitised exposures). It is recognized that under certain circumstances this could lead to different outcomes between the different options when measuring the retention requirement; for instance, if the securitisation benefits from overcollateralization (i.e. the nominal value of securitised exposures is higher than the nominal value of tranches issued under such

securitisation).

45. It is possible that retention may be met in a manner that can be equated to one of options (a) through (d) in Paragraph 1, albeit on a synthetic or contingent basis, or through the use of derivatives. To give two examples, it could be the case that the originator, sponsor or original lender assumes credit risk via a total return swap (as total return receiver) on the most subordinated tranche of a securitisation, or provides a letter of credit to a securitisation program. Such instances of retention via synthetic, contingent, or derivative means are allowable. However, in such circumstances the entity assuming the credit risk of the securitisation (and thus fulfilling the retention requirement) must be the originator, sponsor or original lender, and it is not sufficient that another entity does so in meeting the retention requirement. Furthermore, in such circumstances where retention is met via a synthetic, contingent, or derivative position or exposure, the retained amount (i.e. calculation of the 5%) should be equal to that of the more explicit and simplified means of fulfilling options (a)-(d) in Paragraph 1. The entity fulfilling the retention requirement should also disclose the form of retention, the calculation methodology, and its equivalence of measurement to the most appropriate of options (a)-(d).

“Vertical slice” retention (option (a))

46. The “vertical slice” retention of at least 5% of the nominal value of each of the tranches under option (a) may also be achieved by retaining at least 5% of the credit risk of each of the securitised exposures, if the credit risk thus retained with respect to such securitised exposures always ranks *pari passu* with, or is subordinated to, the credit risk that has been securitised with respect to those same exposures. As per Recital 24, retention in this form results in the originator, sponsor or original lender retaining “exposure to the risk of the loans in question” notwithstanding what “legal structures or instruments are used to obtain this economic substance”.

47. It is also interpreted that when liquidity facilities⁹ are provided to asset-backed commercial paper programmes¹⁰, then the retention requirement may be met under option (a) in the following circumstances:

- (i). the facility covers the credit risk of the exposures, and not just the liquidity, market disruption or other non-credit-related risks of the securitisation, and the capital requirement for such facility is calculated accordingly;
- (ii). the facility covers 100% of the credit risk of such exposures¹¹;
- (iii). the terms of such facility must ensure that it remains available (on a contingent or drawn basis) for as long as the originator, sponsor or original lender has to meet the retention requirement by means of such

⁹ As defined in Directive 2006/48/EC.

¹⁰ As defined in Directive 2006/48/EC.

¹¹ Such facilities, as a means of meeting the retention requirement, have been mapped to option (a) because the current practice is that they are senior in a securitisation’s waterfall (and so are inherently dissimilar to any of options (b)-(d)); but in order for them to properly qualify under option (a), such facilities would need to cover 100% of the credit risk of a securitisation’s exposures (due to their senior position in the waterfall). However, should facilities exist or be created that are not senior in a securitisation’s waterfall, such facilities could be assessed for meeting the retention requirement under the relevant option; for instance, a junior facility under option (d).

- facility for the relevant securitisation positions;
- (iv). the facility is provided by the sponsor, originator or original lender (and not by any other entity); and
 - (v). the credit institution investing in, or otherwise assuming exposure to, such securitisation has sufficient access to appropriate documentation to enable it to verify conditions (i)-(iv) above.

For the purpose of clarity, an example is provided. A liquidity facility provided to an ABCP conduit by the conduit sponsor, ranking senior to other obligations in the waterfall, but covering 100% of the credit risk of the underlying exposures (i.e. not just funding against performing receivables), with terms that ensure it is available (on a contingent or drawn basis) for as long as the commercial paper is outstanding, could potentially meet the retention requirement under this option (a).

“Originator interest” retention (option (b))

48. The use of this option is applicable not only to securitisations of revolving exposures, but also to revolving securitisations of non-revolving exposures (or revolving securitisations with a combination of revolving and non-revolving exposures). For instance, option (b) could apply equally to a revolving securitisation of credit card loans (where both the securitisation and the exposures are revolving) and to a revolving securitisation of mortgage loans (where only the securitisation is revolving and the exposures themselves are not necessarily revolving). Once again, as per Recital 24, retention in this form results in the originator, sponsor or original lender retaining “exposure to the risk of the loans in question” notwithstanding what “legal structures or instruments are used to obtain this economic substance”.

“On-balance sheet” retention (option (c))

49. The “on-balance sheet” retention option can be used in respect of synthetic securitisations as well as traditional securitisations. However, the exposures that count towards the retention requirement under this “on-balance sheet” retention option cannot also be synthetically securitised (in other words, the originator, sponsor or original lender should not also receive protection against the credit risk of that proportion of the pool of exposures that fulfils the retention requirement).

50. When considering the process for randomly selecting exposures, credit institutions should consider both quantitative and qualitative factors when defining the pool of potentially securitised exposures from which the exposures retained and the exposures securitised are drawn, and consequently only truly “random” differences should exist or evolve between the retained and securitised exposures. Such factors may include the distribution, weighted averages, or stratifications of such factors as: vintage, product, geography, origination date, maturity date, LTV, property type, industry sector, debt service coverage ratio, interest coverage ratio, and outstanding loan balance. Bearing in mind that the specific targeted risk factors of each pool of potentially securitised exposures will depend on legitimate business decisions taken by originators, sponsors or original

lenders, this is a non-exhaustive list of factors that might apply for certain types of securitisation. Such risk factors, used in defining the pool of potentially securitised exposures, should be disclosed clearly to investors for due diligence purposes.

51. The requirement that the number of potentially securitised exposures is no less than 100 at origination means that the pool of potentially securitised exposures from which the 5% of randomly selected exposures is drawn contains no less than 100 exposures, not that the randomly selected retained exposures themselves consist of no less than 100 exposures. Notwithstanding this specific number, as a general principle, the choice of option (c) as a method of fulfilling the retention requirement is intended primarily for granular pools of securitised exposures, and should option (c) be used the outcome of the random selection process should not result in either the retained or securitised portion being overly concentrated.
52. Given the clarification of the phrase “potentially securitised exposures” above, the requirement that “retention of randomly selected exposures, equivalent to no less than 5% of the nominal amount of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation” means that the retained exposures are calculated as 5.0% (5/100), not as 4.76% (5/105).
53. When the retention requirement is fulfilled using option (c), the randomly selected exposures that are retained to meet the requirement should be a static pool of exposures, i.e. it is not possible for a sponsor, originator or original lender to, at different points in time, designate different exposures as being those that enable it to fulfil the retention requirement, except insofar as this is done to fulfil the requirements with respect to a securitisation in which the revolving balance of securitised exposures fluctuates over time (with such replenishment being subject to the guidance on randomness provided in clause 50 above).

“First loss” retention (option (d))

54. With respect to option (d), the phrase “retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors” means retention of such first loss tranche and, if necessary, other contiguous positions that are senior to it, but are still the same as, or junior to, any position transferred or sold to investors.
55. A “first loss tranche” may consist of such exposures as a subordinated note, a reserve account (on which, however, see clause 58 below), an equity interest¹², a preference share interest, or a deferred purchase price element. This is a non-exhaustive list of positions or exposures that could be eligible under option (d). It is also possible that such “first loss” exposures under this option (d) are created on a contingent, synthetic or derivative basis; for

¹² The term “equity” is not used here specifically in accounting terms, but in broader market terms, in which it is commonly used to refer to the first loss position of a securitisation.

instance, via a total return swap or letter of credit (on which, however, see clauses 45 above and 57 below).

56. While option (d) expresses the “first loss” exposure in terms of the liability structure of a securitisation (i.e. it expresses it specifically as a first loss “tranche”), there may be circumstances in which the retention of such a “first loss” exposure by the originator, sponsor or original lender is instead achieved by comparable (but not identical) means. For instance, the originator, sponsor or original lender may overcollateralize the liabilities of a securitisation, and such overcollateralization is the exposure of the originator, sponsor or original lender to the securitisation, and such overcollateralization acts as a “first loss” cushion protecting the liabilities issued by the securitisation against the credit risk of the first losses on such securitised exposures. In such circumstances, measurement of the retained amount (i.e. calculation of the 5%) should be equal to that of the more explicit and simplified means of fulfilling options (a)-(d) in Paragraph 1. The entity fulfilling the retention requirement should also disclose the form of retention, the calculation methodology, and its equivalence of measurement to the most appropriate of options (a)-(d).
57. A letter of credit, guarantee or similar form of credit support may also be a permissible form of retention under this option (d), provided that:
- (i). it covers the credit risk of the exposures, and not just other non-credit-related risks;
 - (ii). it covers at least 5% of the credit risk of such exposures, and it has assumed a first-loss position with respect to the securitisation¹³;
 - (iii). it covers such credit risk for as long as the originator, sponsor or original lender has to meet the retention requirement by means of it for the relevant securitisation positions;
 - (iv). it is provided by the sponsor, originator or original lender (and not by any other entity); and
 - (v). the credit institution investing in, or otherwise assuming exposure to, such securitisation has sufficient access to appropriate documentation to enable it to verify conditions (i)-(iv) above.

To give one example, it is possible that stand-by letters of credit, provided as program-wide credit enhancement to ABCP conduits by the conduit sponsor, might be able to fulfil the retention requirement under option (d) under the above approach, assuming that they meet the requirements outlined in conditions (i)-(v) above. While it is not possible to address all possible forms of letters of credit or guarantees in this guidance, these principles should provide a reasonable basis for assessment.

58. Only funded reserve accounts (or the funded portion of a reserve account, if partially funded) fulfil the retention requirement; an unfunded reserve account (or the unfunded proportion of a partially funded reserve account) that is to be funded (for instance, via future excess spread) does not fulfil the

¹³ However, it is recognised that in certain circumstances (for instance, ABCP conduits) it may constitute a second-loss exposure at the securitisation program-wide level, as a first-loss exposure at the transaction-specific level underlying this program-wide level is assumed by the originators or original lenders of the underlying exposures.

retention requirement. Furthermore, a reserve account that fulfils the retention requirement under this option (d) should have the capacity to absorb principal losses on the underlying exposures, and should not have its usage delimited to non-credit related circumstances, such as yield supplement on the underlying exposures, covering temporary interest shortfalls, covering market disruption events, etc (this is a non-exhaustive list).

59. Whereas both Recital 25 and Paragraph 3 outline the non-applicability of the provisions of Article 122a to purchased receivables (with Recital 25 explicitly specifying those purchased receivables that are “transferred at a discount”), should such exemptions not apply for any reason to transactions in which the receivables are sold with a refundable purchase discount, then such refundable purchase discount would qualify as a first loss tranche under option (d). See also clause 60 below for further clarification on meeting the retention requirement under option (d) by way of sale of exposures at a discount.

60. In certain securitisations (such as those of ABCP conduits), the retention requirement could be fulfilled under option (d) if, for the relevant discrete transactions underlying the conduit, the originator or original lender has retained a 5% net economic interest in the underlying securitised exposures, or in the securitisation positions arising from that transaction, including by way of sale of the exposures at a discount of at least 5%. This would be a potential means not only for investors in such securitisation to ensure retention has been met, but also for those assuming other forms of exposure to such securitisation (for instance, a liquidity facility provider to an ABCP conduit) to ensure retention has been met. However, in such circumstances it should be ensured that there is sufficient discrimination between sale at a discount for purposes of yield (e.g. to meet funding costs) and sale at a discount for purposes of credit risk, such that there is a retained net economic interest of at least 5% for the purposes of credit risk alone. Furthermore, where the discount for purposes of credit risk is not refundable – i.e. the sale is outright, with the originator or original lender retaining no net economic interest – this does not meet the intent of Article 122a (to ensure alignment of interest), and is not a permissible means of meeting the retention requirement.

Multiple application of the retention requirement

61. The Directive requires that there “shall be no multiple applications of the retention requirement”. The text does not mean that there is a prohibition on multiple applications; rather that, as outlined in Recital 24, it suffices that for any given securitisation only one of the originator, sponsor or original lender is subject to the requirement. Therefore, multiple application of the retention requirement by different parties to the transaction is not mandated by the Directive.

62. For a resecuritisation, from the perspective of the investor in that resecuritisation, fulfilment of the retention requirement would apply only to the second (“repackaged”) layer of the transaction (in which it is investing), and not to the first (“underlying”) layer of the transaction (i.e. the

securitisations that underlie the second layer). More specifically, the phrase “there shall be no multiple applications of the retention requirement” means that there shall be no requirement for multiple retention either by individual parties to the transaction or by individual SPVs within the structure of the transaction; however, there may be instances of multiple retention at the overall transaction level as an outcome of the resecuritisation process itself. For instance, where a transaction is the resecuritisation of existing securitisations, this may result in retention occurring at more than one level in the overall transaction (i.e. in both the underlying securitisations and in the newly created resecuritisation). However, this is an outcome of the resecuritisation process itself, and is not necessary to fulfil the requirements of Article 122a. Conversely, if the presence of two SPVs in a transaction is the result of the transaction’s overall legal structure or the securitisation law of individual jurisdictions (e.g. the need for a discrete borrower SPV and an issuer SPV, or financing via certain co-funding structures that require more than one SPV), this will neither require multiple application of retention under Article 122a, nor will it necessarily indirectly lead to multiple retention as an outcome. However, both in the context of resecuritisations and more generally, credit institutions should be particularly sensitive to the use of intermediating SPVs, and should not invest in structures which may result in avoidance of the economic substance of the retention requirement.¹⁴

63. Although for a resecuritisation there is no requirement for the investing credit institution to ensure that retention is met also at the first layer (i.e. the underlying securitisations), as it is only required to do so at the second layer (in which the investment is made), it could be the case that credit institutions investing or assuming exposure to such resecuritisations deem information on whether retention at this first layer is met or not to be material for credit analysis (in fulfilling their obligations under Paragraphs 4 and 5), or credit institutions acting as sponsors or originators deem such information to be material for the purposes of transparency and disclosure (in fulfilling their obligations under Paragraph 7).

Other issues and clarifications

64. The minimum required retention level specified in Paragraph 1 is 5%, but there is nothing to prevent the actual retention level from being higher than this.¹⁵

¹⁴ In practice, it is likely that the retained interest of resecuritisations will be held by the sponsor of such resecuritisations.

¹⁵ See Report from the Commission to the Council and the European Parliament: Expected Impact of Article 122a of Directive 2006/48/EC (COM(2010)262, 28 May 2010): “Regarding the specific question of the effectiveness of the minimum retention level chosen, the Commission concludes that the existing moderate minimum retention level of 5% should be kept, acknowledging that investors should require higher retention levels depending on the securitisation in question.” See also *CEBS Technical Advice on the Effectiveness of a Minimum Retention Requirement for Securitisations* (30 October 2009) where it is concluded that there is no strong evidence that a change in the retention percentage (from 5% to any other single number) would result in better alignment of (economic) interest between originators and investors: “Any assessment of whether an increase in the retention requirement is necessary begins with the suitability of the current requirement of 5%. It is difficult to provide conclusive evidence on the adequacy of 5% as the effectiveness of the alignment it creates will vary across asset classes, structures and geographies.”

65. The phrase “the net economic interest shall be determined by the notional value for off-balance sheet items” is interpreted as follows. Should the exposures, receivables or cashflows being securitised consist of, or include, an undrawn, unrealised, contingent or future component, then the retention requirement of 5% is dynamic in that it only applies to such undrawn, unrealised, contingent or future components at such future point in time when they are drawn, realised, crystallized or received, and not before such time. For example, in a securitisation of credit card receivables, the retention requirement would apply only to the outstanding balance of the receivables, and not to the full balances/limits available to the borrowers, but could dynamically adjust as such available balances/limits become drawn to constitute receivables (for instance, via adjustment to the size of the seller interest in a revolving securitisation under option (b)).¹⁶
66. When the retention requirement is fulfilled using any of options (a) through (d), the retained exposures or positions may be available to be used by the sponsor, originator or original lender as collateral for secured funding purposes, as long as credit risk of these retained exposures or positions is not transferred to a third party in such secured funding arrangements.
67. Paragraph 1 specifies that “retained positions [...] are not hedged or sold”. The use of the word “sold” in this context does not preclude the party with the retained interest from using it for secured funding in a repo transaction, if, in such transaction, the party with the retained interest is not transferring the credit risk of such retained interest, as would typically be the case under standard repo agreements (such as the TBMA/ISMA Global Master Repurchase Agreement) when undertaken on commercial terms.
68. Similarly, should option (c) be chosen to meet the retention requirement, the principal consideration should be that the credit risk of the retained exposures that fulfil such retention requirement is not transferred from the originator, sponsor or original lender, and is not available for such transfer, regardless of whether such exposures are subsequently used for funding purposes (and regardless of whether such funding is in structured or unstructured form).
69. CEBS is aware that it may be possible to engineer circumstances in which the retention requirement is technically met, albeit with the retaining party (originator, sponsor or original lender) having asymmetric (“upside” and not “downside”) exposure to such securitisation. For instance, as retention is defined in nominal terms (as opposed to market value terms), securitisation of exposures at a discount to market value (either via true sale or synthetically) could result in such a situation.¹⁷ CEBS and competent authorities will monitor the extent to which retention is undertaken in a form that exposes the retaining party only to the “upside” rewards and not to the “downside” risks of such securitisations as part of its post-implementation

¹⁶ In this respect, use of the adjective “notional” (as opposed to “nominal”) refers to the distinction between contingent commitments and actual receivables, not to the distinction between synthetic and cash securitisations.

¹⁷ In this respect, see also clause 60 on discriminating between sale at a discount for purposes of yield and sale at a discount for purposes of credit risk.

review on the effectiveness of Article 122a in ensuring alignment of interests under Paragraphs 9-10.

Paragraph 2

Paragraph 2

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

General considerations

70. Paragraph 2 allows the retention requirement to be met on the basis of the consolidated situation (rather than at the individual solo level) provided each institution involved in the securitisation is included within the scope of supervision on a consolidated basis. This allows different institutions within a group to take part in different securitisations, whilst ensuring that any institutions involved are still exposed to retained credit risk (by virtue of consolidation) and incentives remain aligned. However, Paragraph 2 may only be used where the institutions have committed to ensure that the requirements of both Paragraphs 6 and 7 are also fulfilled. It should also be noted that Paragraph 1 is very clear that the retained interest must not be hedged or sold. In circumstances where the entity that retained the interest in the securitisation on behalf of other group entities is subsequently divested from the group, one or more other group entities must acquire exposure to the securitisation so as to ensure ongoing fulfilment of the retention requirement.
71. The ability to fulfil the requirements of Paragraph 1 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 under the Directive (as provided in clause 24 above) 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.

Paragraph 3

Paragraph 3

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

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

Paragraph 1 shall not apply to:

- a) transactions based on a clear, transparent and accessible index, where the underlying reference entities are identical to those that make up an index of entities that is widely traded, or are other tradable securities other than securitisation positions; or*
- b) syndicated loans, purchased receivables or credit default swaps where these instruments are not used to package and/or hedge a securitisation that is covered by paragraph 1.*

General considerations

72. The exemptions provided under Paragraph 3 are exemptions to the retention requirement of Paragraph 1; they are not exemptions to other requirements in other paragraphs of Article 122a. However, there may be instances in which certain types of exposure or instrument designated in this Paragraph 3 as being exempt from the provisions of Paragraph 1 might not, in any case, fall under the definition of a securitisation under Article 4(36) of Directive 2006/48/EC, and, as such, would in any case be exempt not just from the provisions of Paragraph 1, but from those of Article 122a as a whole, even in the absence of this Paragraph 3.

Correlation trading portfolios

73. The exemptions provided under Paragraph 3 where “transactions [are] based on a clear, transparent and accessible index [...] or are other tradable securities other than securitisation positions” are assumed to constitute a scope that equates with the definition of a “correlation trading portfolio” as described under the Directive 2010/76/EU amendments to Directive 2006/49/EC (“CRD 3”). The exemptions provided in Paragraph 3 extend to all positions that are encompassed by the correlation trading activities as described in the above amendments.

74. By way of example only (and not as a delimitation of the scope referred to in clause 73 above), CDX and iTraxx are examples of clear, transparent and accessible indices to which the provisions of Paragraph 1 would not apply.

Credit default swaps

75. As a corollary to clause 72 above, the exemption with respect to “credit default swaps where these instruments are not used to package and/or hedge a securitisation that is covered by paragraph 1” is interpreted to simply clarify what may already be self-evident, i.e. that credit default swaps are not by definition an exposure type that is automatically within the scope of Article 122a (including Paragraph 1 thereof), unless such credit default swaps constitute securitisation positions. For instance, selling protection on a collateralised debt obligation (hereafter, “CDO”) via a credit default swap would not be exempted under Paragraph 3 (and consequently would be subject to the retention requirement under Paragraph 1), but selling protection on a corporate entity that does not constitute a securitisation would typically be exempt under Paragraph 3 (and consequently would not be subject to such requirements).
76. Under Article 96, clause 2 of Directive 2006/48/EC, the provider of credit protection to securitisation positions is considered to hold positions in the securitisation, and is, therefore, subject to Article 122a in the same manner as an investor. Therefore, a credit institution must not provide credit protection to securitisation positions where the securitisation does not comply with Article 122a (1). Consequently, in terms of buying protection versus selling protection:
- (i). When a credit institution buys protection on a securitisation (for instance, via a credit default swap), such purchase of protection is not subject to the requirements of Paragraph 1.
 - (ii). However, when a credit institution sells protection on a securitisation (for instance, via a credit default swap), such sale of protection is subject to the requirements of Paragraph 1.
 - (iii). Therefore, the phrase “Paragraph 1 shall not apply to [...] credit default swaps where these instruments are not used to package and/or hedge a securitisation that is covered by paragraph 1” means that the requirements of Paragraph 1 shall apply when such instrument is used to hedge a securitisation position, but only when a credit institution is selling protection (i.e. assuming exposure to such securitisation) and not when a credit institution is buying protection (i.e. transferring exposure to such securitisation).

Paragraph 4

Paragraph 4

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

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

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

General considerations

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

78. The requirements in Paragraph 4 should be carried out "before investing", and "as appropriate thereafter". A credit institution should consider the need to review compliance if there is a material change in the performance of the

positions or exposures, or if certain events occur that potentially impact such securitisation (for example, if a contractual trigger is breached, or if the originator, sponsor or original lender becomes insolvent). Credit institutions should also consider the need to review compliance if the analysis originally undertaken is no longer appropriate, for example, due to the application of updated policies and procedures to their trading book or non-trading book, or due to changes in the risk profile of their investment.

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

80. Where exposures have not yet been securitised (e.g. during the “ramp-up” period of a securitisation, or where exposures may be substituted into an existing revolving securitisation), due diligence may be performed on the eligibility criteria of exposures in the absence of information on the exposures actually securitised or to be securitised.

Correlation trading portfolios

81. Where positions that are subject to the requirements of Paragraph 4 pertain to correlation trading activities (for instance, such activities as those referred to among the exemptions from Paragraph 1 listed in Paragraph 3), then the requirements under Paragraph 4 for such positions can generally be deemed to be met by fulfilling the relevant requirements for capturing the risks of such positions under the Annex V amendments to Directive 2006/49/EC provided in Directive 2010/76/EU.¹⁸

Trading book/non-trading book

82. As a general principle, credit institutions should apply the same policies and procedures to securitisation positions in their trading book and non-trading book. However, credit institutions may distinguish between the trading book and non-trading book as long as it is appropriate and can be justified. The classification that a position is in the trading book is not sufficient justification in and of itself. Firms must be able to justify any differentiation between policies and procedures that are applied due to securitisation positions being in their trading book versus their non-trading book and/or due to the risk profile of their investment differing in such circumstances. As the analysis undertaken for securitisation positions may be different depending on the risk

¹⁸ Annex V allows for different approaches to calculate the capital requirement of a correlation trading portfolio. A credit institution’s use of the provisions of Annex V to fulfil the requirements of Paragraph 4 should be driven by the risk profile of its correlation trading portfolio, and not be constrained by the minimum requirements under Annex V that arise from its capital treatment of that same correlation trading portfolio. Where a credit institution’s approach to calculating the capital requirement of a correlation trading portfolio does not result in a comprehensive and thorough understanding of the risk profile of its investments in the securitised positions, the firm must take appropriate additional steps to ensure the relevant obligations under Article 122a are satisfied.

profile of the trading book versus the non-trading book, when interpreting the requirements of Paragraph 4 in the context of a trading book, the terms “appropriate” and “commensurate with the risk profile” should be given strong weight, as well as the statement of Recital 27 that “due diligence obligations need to be proportionate”. Consequently, the specific elements outlined in clauses (a) through (g) of Paragraph 4 should not be regarded as a minimum threshold to be met on a mechanical basis. In other words, specific elements of such clauses (a)-(g) may be of greater, lesser, or negligible importance, depending on the specific characteristics and risk profile of the trading book. Thus, while the scope of due diligence is defined by clauses (a)-(g) of Paragraph 4, the intensity of such due diligence with respect to each of these specific elements may vary (if justified) according to the specificities of the trading book versus the non-trading book. However, see clause 85 below on actions to be undertaken should the risk profile of the trading book change over time.

83. For example, in fulfilling the requirement to analyse and record policies that “ensure the independence of the valuer” of the collateral (in sub-clause (f) of Paragraph 4), both the necessity (in terms of materiality) and the plausibility (in terms of time horizon) of undertaking such an activity before investing may differ for the trading book versus the non-trading book. Consequently, assuming that the risk profile of the trading book is truly different to that of the non-trading book, the extent to which this is appropriate as a requirement before investing may be assessed differently for the trading book versus the non-trading book.
84. As a counter-example, with respect to the requirement to analyse and record “the reputation and loss experience in earlier securitisations of the originators or sponsors”, as per sub-clause (d) of Paragraph 4, it is unlikely (assuming that such loss information is freely available for previous public transactions of the same originator or sponsor) that the means of fulfilling this requirement would differ as materially for the trading book versus the non-trading book.
85. In determining whether different policies and procedures should apply to its trading and non-trading books, a credit institution should consider all relevant factors that impact the risk profile of these books and their positions. This could include, for example, the size of the positions, the impact on the credit institution’s capital base during a period of stress, and the concentration of risk in any one specific transaction, issuer, or asset class. To give a specific example, the trading desk of a credit institution could, as part of its market-making activities, be requested by clients to bid on baskets of securitisation positions as a whole, where the precise requirements of each of clauses (a)-(g) cannot be met on a discrete basis for each specific position in such basket (for instance, due to a short timeframe, unavoidable operational delays in acquiring such information, or the existence of non-remediable gaps or inconsistencies in information availability). However, should such exceptions not be material in the aggregate context of such basket (or indeed in the context of the overall risk profile of the trading book), this should not necessarily impede such credit institution from providing a secondary market in such positions, provided that such credit institution has a suitable framework via “formal policies and procedures” for ensuring control around

such exceptions, follows a prudent process for “analysing and recording” such exceptions, and has a process for ensuring that such exceptions are “commensurate with the risk profile” of its trading book (in each case, as per the requirements of Paragraph 4). In this respect, it should be noted that it is specified in Paragraph 5 that additional risk weights should only be applied when the requirements of the relevant paragraphs – including Paragraph 4 – are not met “in any material respect”. However, if circumstances change (for instance, turnover, duration and price transparency within the trading book are negatively impacted by adverse market conditions), then any such change in risk profile should be matched with a commensurate change in due diligence requirements. Credit institutions should specify in their trading book policy the circumstances that would trigger a commensurate change in their due diligence requirements.

Clarification of specific clauses

86. In relation to clause (a) and (c) of Paragraph 4, as part of an effective due diligence process, a credit institution should also consider the nature and substance (contractual or otherwise) of the disclosure given by the originator, sponsor or original lender to maintain the net economic interest and to make accessible relevant data on the underlying exposures on an on-going basis.
87. In relation to clause (b) of Paragraph 4, a sample of the risk characteristics that a credit institution should consider with respect to their individual securitisation positions could include tranche seniority level, cash flow profile, rating, historical performance of similar tranches, bond covenants, credit enhancement, etc.
88. In relation to clause (c) of Paragraph 4, a sample of the risk characteristics that a credit institution should consider with respect to the underlying exposures is contained in Paragraph 5, which pertains mostly to residential mortgages. While these are appropriate to this specific asset class, investors should use appropriate and comparable metrics for other asset classes.
89. In relation to clause (f) of Paragraph 4, it is stated that the methodologies and concepts on which the valuation of the collateral is based should be analysed and recorded where applicable. It is specified that the requirement to evaluate methodologies and concepts of the valuation should only be undertaken “where applicable” (i.e. where valuation of collateral is relevant and material), and the requirement to ensure “independence of the valuer” should, likewise, only be undertaken where this is relevant and material. To give an example, this may be more relevant and material for a non-granular CMBS securitisation (where valuation of the underlying real estate is a key component of credit analysis) than for a granular credit card securitisation (where the borrowers’ loans are unsecured).
90. In relation to clause (g) of Paragraph 4, a sample of the structural features that credit institutions could consider that can materially impact the performance of their position would include waterfalls, triggers, swaps, liquidity facilities, reserve accounts, guarantees, sponsor support mechanisms, etc.

Scope delimitation in fulfilling due diligence requirements

91. The requirements of credit institutions when investing in securitisations, as outlined in Paragraph 4, need not extend to the analysis and recording of information that would breach other legal or regulatory requirements (such as market abuse and confidentiality restrictions).

Stress testing

92. The stress tests that credit institutions must undertake should be incorporated into broader stress-testing that is regularly undertaken by a credit institution. CEBS has provided guidelines on stress testing in August 2010: *“CEBS Guidelines on Stress-Testing (GL32)”*.¹⁹ These stress-testing guidelines set out the expectation that credit institutions will ensure that they have appropriate stress testing governance and infrastructure in place and identify the relevant “building blocks” required for an effective stress-testing programme. In addition, Annex II of the guidelines includes specific principles in relation to securitisation.

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

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

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

Other issues

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

¹⁹ These can be found at: http://www.c-eps.org/documents/Publications/Standards---Guidelines/2010/Stress-testing-guidelines/ST_Guidelines.aspx.

Paragraph 5

Paragraph 5

Credit institutions, other than when acting as originators or sponsors or original lenders, shall establish formal procedures appropriate to their trading book and non-trading book and commensurate with the risk profile of their investments in securitised positions to monitor on an ongoing basis and in a timely manner performance information on the exposures underlying their securitisation positions. Where relevant, this shall include the exposure type, the percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, collateral type and occupancy, and frequency distribution of credit scores or other measures of credit worthiness across underlying exposures, industry and geographical diversification, frequency distribution of loan to value ratios with bandwidths that facilitate adequate sensitivity analysis. Where the underlying exposures are themselves securitisation positions, credit institutions shall have the information set out in this subparagraph not only on the underlying securitisation tranches, such as the issuer name and credit quality, but also on the characteristics and performance of the pools underlying those securitisation tranches.

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

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

General considerations

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

Correlation trading portfolios

98. Where positions that are subject to the requirements of Paragraph 5 pertain to correlation trading activities (for instance, such activities as those referred to among the exemptions from Paragraph 1 listed in Paragraph 3), then the requirements under Paragraph 5 for such positions can generally be deemed to be met by fulfilling the relevant requirements for capturing the risks of such positions under the Annex V amendments to Directive 2006/49/EC provided in Directive 2010/76/EU.²⁰

Frequency and intensity of monitoring exposures and positions

99. The frequency of a formal assessment of compliance with provisions regarding ongoing monitoring outlined in Paragraph 5 should be at least annual; however, a credit institution should consider the need to review compliance with these provisions if there is a material change in the performance of the positions or exposures, or if certain events occur which impact such securitisations (for example, if a contractual trigger is breached, or if the originator, sponsor or original lender becomes insolvent).

100. The interpretation of the terms “commensurate with the risk profile” and “appropriate to their trading and non-trading book” in this paragraph, especially with respect to any potential differentiation made between the trading and non-trading books, should be taken in light of the guidelines to implementation of Paragraph 4 given under clauses 82-85 above.

Additional risk weights for infringements

101. The total risk weight that would apply to a securitisation position (or positions) as a result of the application of Paragraph 5 is:

$$\text{MIN}(12.5, \text{RW}_{\text{Original}} * (1 + ((2.5 + (2.5 * \text{InfringementDuration}_{\text{Years}})) * (1 - \text{Para3Exemption}_{\text{Pct}}))))$$

The foregoing formula produces the combined risk weight that would apply to such position, including both the original and the additional risk weight.

102. In determining the foregoing formula:

- (i). 12.5: The text of Paragraph 5 provides that the additional risk weight is “capped at 1250%”. This could, in certain circumstances, result in the overall capital required to be held against a securitisation position exceeding the exposure value of the relevant securitisation position. Notwithstanding this, should the competent authority “progressively increase the risk weight”, the cumulative result of such progressive increases should avoid circumstances in which capital required to be held against a securitisation position exceeds the exposure value of that position. As a result, the above formula caps the total risk weight (not the additional risk weight) at 1250%.
- (ii). $\text{RW}_{\text{Original}}$: As per Paragraph 5, this is “the risk weight [...] which would, but for this paragraph, apply to the relevant securitisation positions”.

²⁰ See also footnote 19 under Paragraph 4.

Sample input: "0.07" for certain securitisation positions of credit quality step 1.

- (iii). 2.5: Paragraph 5 specifies that "the competent authorities impose a proportionate additional risk weight of no less than 250% of the risk weight [...] which would, but for this paragraph, apply to the relevant securitisation positions". This component of the formula fulfils these provisions.
- (iv). InfringementDuration_{Years}: Paragraph 5 specifies that the competent authority "shall progressively increase the risk weight with each subsequent infringement". In this context, the term "infringement" must be understood as non-compliance with one or more of the requirements of Article 122a susceptible of giving rise to an additional risk weight, and the term "subsequent" refers to the passage of time. Consequently, this input contains the duration of the infringement, expressed in years, with the input as an integer (not a fraction), i.e. expressed in terms of discrete 12-month periods of infringement, rounded down (not up) to the nearest 12-month period. The duration will typically be measured from the starting point of the infringement by a credit institution, but may also be measured from other points in time (e.g. the time of identification of infringement by the competent authority, the time of identification of infringement by the credit institution, the time of acquisition of the position or assumption of the exposure by the credit institution, etc), depending on the specific circumstances or nature of the infringement. Sample inputs: "0" for an infringement of less than 12 months; "1" for an infringement of greater than 12 months, but less than 24 months; "2" for an infringement of greater than 24 months, but less than 36 months, etc.
- (v). Para3Exemption_{Pct}: Paragraph 5 specifies that "competent authorities shall take into account the exemptions for certain securitisations provided in paragraph 3 by reducing the risk weight it would otherwise impose under this Article in respect of a securitisation to which paragraph 3 applies". The fixed inputs for this element are "0.5" where exemptions relate to the first sub-paragraph of Paragraph 3, and "0.25" where exemptions relate to the second sub-paragraph of Paragraph 3.

103. For instance, if there were a 2-year infringement on a securitisation position that had an initial risk weight of 7%, but was subject to a Paragraph 3 exemption under sub-paragraph 1 of Paragraph 3, the calculation would be as follows:

$$\text{MIN}(12.5, 0.07 * (1 + ((2.5 + (2.5 * 2)) * (1 - 0.5)))) = 33.25\%$$

calculated as follows:

$$\begin{aligned} &\text{MIN}(12.5, 0.07 * (1 + ((2.5 + (5)) * (0.5)))) \\ &\text{MIN}(12.5, 0.07 * (1 + ((7.5) * (0.5)))) \\ &\text{MIN}(12.5, 0.07 * (1 + (3.75))) \\ &\text{MIN}(12.5, (0.07 * 4.75)) \\ &\text{MIN}(12.5, 0.3325) \\ &= 33.25\% \end{aligned}$$

As another example, if there were a 6-year infringement on a securitisation position that had an initial risk weight of 60%, but was not subject to any Paragraph 3 exemptions, the calculation would be as follows:

$$\text{MIN}(12.5, 0.6 * (1 + ((2.5 + (2.5 * 6)) * (1 - 0)))) = 1,110\%$$

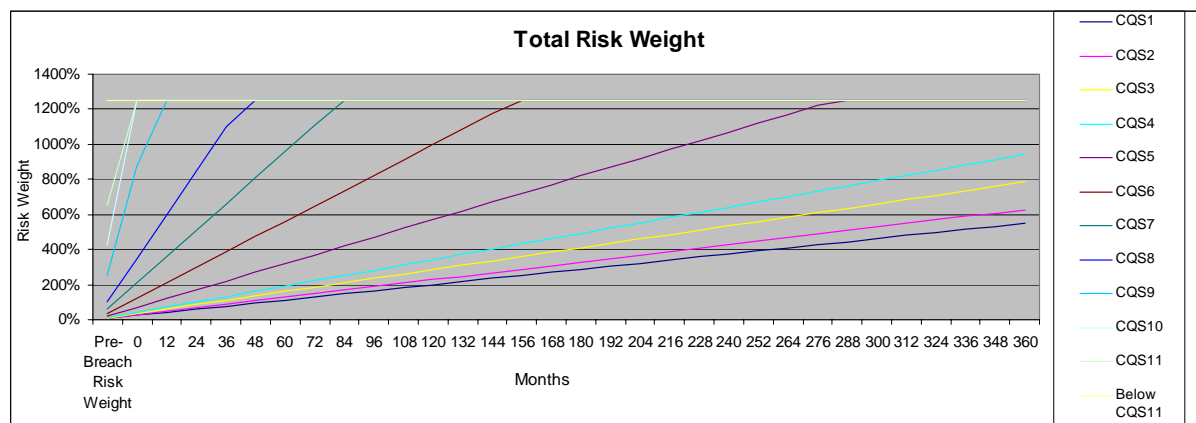
However, in the following year, if not remedied, this would, in this example, become a 7-year infringement, and the outcome for this specific position would automatically (under the formula above) become subject to the cap of 1,250% for the total risk weight applied to the position:

$$\text{MIN}(12.5, 0.6 * (1 + ((2.5 + (2.5 * 7)) * (1 - 0)))) = 1,250\%$$

104. For purposes of clarity, and to illustrate the behaviour of the total risk weights (initial plus additional) over time, some examples are provided below. The following table sets out the total risk weights that would be applied to securitisation positions with various initial risk weights that do not benefit from any Paragraph 3 exemptions, expressed as a function of time in 1-year increments up to 8 years for infringements that are unremedied during such periods.²¹

CQS	RW	Years in Breach									
		0	1	2	3	4	5	6	7	8	
CQS1	7%	25%	42%	60%	77%	95%	112%	130%	147%	165%	
CQS2	8%	28%	48%	68%	88%	108%	128%	148%	168%	188%	
CQS3	10%	35%	60%	85%	110%	135%	160%	185%	210%	235%	
CQS4	12%	42%	72%	102%	132%	162%	192%	222%	252%	282%	
CQS5	20%	70%	120%	170%	220%	270%	320%	370%	420%	470%	
CQS6	35%	123%	210%	298%	385%	473%	560%	648%	735%	823%	
CQS7	60%	210%	360%	510%	660%	810%	960%	1110%	1250%	1250%	
CQS8	100%	350%	600%	850%	1100%	1250%	1250%	1250%	1250%	1250%	
CQS9	250%	875%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	
CQS10	425%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	
CQS11	650%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	
Below CQS11	1250%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	

The following graph illustrates the same, albeit for up to 30 years.



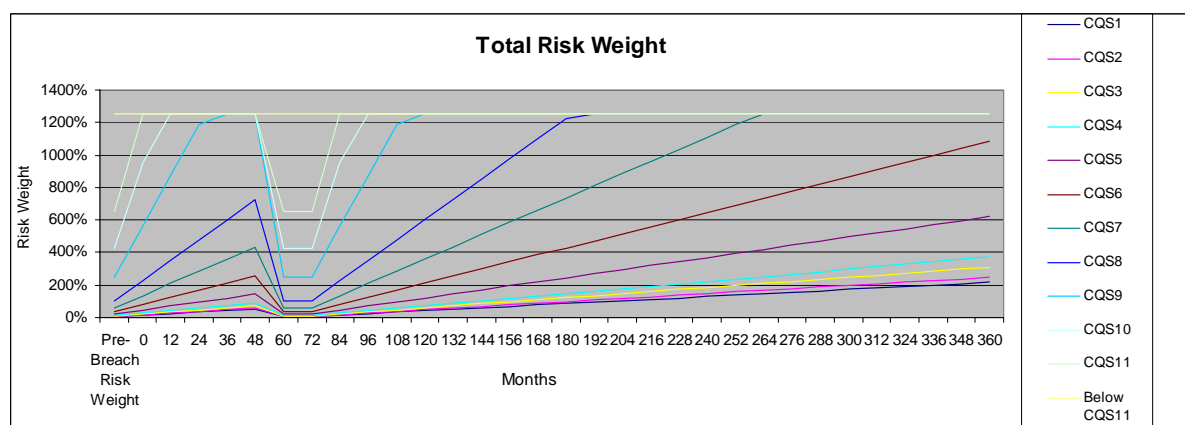
The following table sets out the total risk weights that would be applied to securitisation positions with various initial risk weights that do benefit from

²¹ All numbers in the tables and graphs should be treated as illustrative of potential outcomes of the calculations only. These tables and graphs should not be read as a fixed scale of total risk weights that result from various infringement scenarios, and neither should the relationship between credit quality steps and risk weights provided in such tables and graphs be interpreted in isolation from the sources of the definitive relationship between credit quality steps and risk weights provided elsewhere in the Capital Requirements Directive.

Paragraph 3 exemptions (under sub-paragraph 1 thereof), expressed as a function of time in 1-year increments up to 8 years, but for infringements that are remediated for two years (years 5 and 6), but are then infringed again (starting in year 7).

CQS	RW	Years in Breach									
		0	1	2	3	4	5	6	7	8	
CQS1	7%	16%	25%	33%	42%	51%	7%	7%	16%	25%	
CQS2	8%	18%	28%	38%	48%	58%	8%	8%	18%	28%	
CQS3	10%	23%	35%	48%	60%	73%	10%	10%	23%	35%	
CQS4	12%	27%	42%	57%	72%	87%	12%	12%	27%	42%	
CQS5	20%	45%	70%	95%	120%	145%	20%	20%	45%	70%	
CQS6	35%	79%	123%	166%	210%	254%	35%	35%	79%	123%	
CQS7	60%	135%	210%	285%	360%	435%	60%	60%	135%	210%	
CQS8	100%	225%	350%	475%	600%	725%	100%	100%	225%	350%	
CQS9	250%	563%	875%	1188%	1250%	1250%	250%	250%	563%	875%	
CQS10	425%	956%	1250%	1250%	1250%	1250%	425%	425%	956%	1250%	
CQS11	650%	1250%	1250%	1250%	1250%	1250%	650%	650%	1250%	1250%	
Below CQS11	1250%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	1250%	

The following graph illustrates the same, albeit for up to 30 years, and assumes that when the infringements recur in year 7, they are unremediated for the entire remaining period illustrated.



105. The above framework offers a common approach to be adopted by competent authorities where infringements are identified, whilst not necessarily requiring application on a rigid and undifferentiated basis. In particular, the following should be noted:

- (i). While the above formula begins and increases in increments of 250%, a competent authority could determine that higher initial starting points and increments are required, depending on the type and circumstances of the infringement.²² However, given that the minimum additional risk weight specified in Paragraph 5 is 250%, it would not be expected that a lower additional risk weight would be specified by such competent authority. (On Paragraph 3 exemptions, which could reduce such additional risk weight below 250%, see previously).
- (ii). While the above formula increases risk weights for unremedied infringements in discrete intervals of one year, a competent authority

²² For example, a competent authority could choose to apply an additional risk weight of 1000% for infringement of ensuring disclosure, 500% for infringement of stress testing, 750% for infringement of monitoring performance, etc.

could determine that a different frequency of increase (for instance, semi-annual) is more appropriate due to the type and circumstances of the infringement.

- (iii). While the above formula applies fixed reductions of 0.5 and 0.25 for the additional risk weight where infringements relate to positions that benefit from the exemptions of sub-paragraphs 1 and 2 of Paragraph 3, respectively, competent authorities could determine that a higher or lower reduction should apply, depending on the type and circumstances of the infringement.
- (iv). More generally, it is possible that a competent authority could apply additional risk weights that amend the inputs and calculations of the above approach. For instance, a competent authority could adopt an approach in which additional risk weights do not increase as a function of time, but instead increase as a function of the number of infringement occurrences identified.
- (v). It is expected that the annual 122a compliance reports of competent authorities and CEBS would be an appropriate opportunity to assess the suitability of the common approach suggested above, and to account for circumstances in which competent authorities diverged from this due to the circumstances and types of infringements observed.
- (vi). Finally, it is possible that the inputs and parameters of the common approach suggested above could also be subject to review, and potentially to adjustment, based on the findings of these same annual reports.

106. The relevant securitisation position(s) to which the additional risk weight is applied could (depending on the circumstances) be an individual securitisation position or multiple securitisation positions, depending on whether the requirements are not being met in any material respect for an individual transaction or for similar transactions in the same asset class, in the same business unit, or in some other combined respect. For the avoidance of doubt, it is intended that when there is non-compliance for an individual transaction, the additional risk weight shall be applied by the credit institution to all exposures arising from that same transaction.

107. Additional risk weights will not necessarily be applied to all securitisation positions due to non-fulfilment of the requirements with respect to one securitisation position.

108. If a securitisation position matures or is sold, it is assumed that the additional risk weight to that position will cease to apply. However, on the potential for additional risk weights to be applied to similar positions (other than that which has matured or been sold), see clause 106.

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

110. The additional risk weight that may be imposed by the competent authority on a securitisation position need not necessarily be of a permanent nature, and such additional risk weight would, in general, subsequently be lifted should the relevant credit institution subsequently meet the requirements of Paragraphs 4, 5 and 7.
111. Additional risk weights are not intended to be applied to circumstances that are beyond the control of the credit institution, if such circumstances do not arise as a result of the negligence or omission of that credit institution. For example, if the retained exposure can no longer be maintained on an ongoing basis by the sponsor, originator or original lender (for instance, because its insolvency has led to asset disposals by the administrator of the now-insolvent sponsor, originator, or original lender), or if the sponsor, originator or original lender having undertaken to fulfil the retention requirement subsequently inadvertently or intentionally breaches such undertaking (for instance, by disposing of the retained interest, contrary to its prior undertaking), this would not by itself trigger increased capital requirements for a credit institution. Actions that are beyond the control of the credit institution will not constitute negligence or omission of that credit institution, provided it has fulfilled, through appropriate due diligence, its requirement to ensure that the originator, sponsor or original lender has explicitly disclosed that it will retain such an interest and would make available sufficient information to allow the investing credit institution to fulfil the other relevant requirements of Article 122a. Similarly, a credit institution would not be obliged to dispose of such a securitisation position in these circumstances (although it could consider adjustments in the management of its exposure to such securitisation position accordingly). However, credit institutions as investors should be sensitive to any potential exploitation, and factor this into any decision to invest in future securitisations of the same sponsor, originator, or original lender. A competent authority may impose the additional risk weights should it determine that a credit institution has not demonstrated that it is sufficiently sensitive to such exploitation.
112. For a credit institution that is in breach of requirements, the question has arisen of how additional risk weights could be applied when the securitisation positions are held in its trading book, and are thus not currently subject to the risk weights that would apply if such positions were held in the non-trading book. This guidance anticipates the outcome of such circumstances with reference to the forthcoming trading book amendments to the Directive ("CRD 3"), and will seek to apply any additional risk weights within the framework of such amendments in a manner that reflects proportionate treatment across the trading and non-trading books.

Paragraph 6

Paragraph 6

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

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

General considerations

113. For an overview of how the provisions of Paragraph 6 apply with respect to the various roles a credit institution can assume in a securitisation, and how these in turn can be mapped to the application of sanctions for non-compliance with the provisions of Paragraph 6, see the section “Considerations on Paragraphs 1-7” above. In particular, the potential for a credit institution to undertake more than one role with respect to a single securitisation, as examined in more detail under clause 16, may be pertinent to this Paragraph 6.

Applying “sound and well-defined” criteria

114. The objective of the requirement, that securitised and non-securitised exposures should be subject to the same sound and well-defined criteria for credit-granting, is to ensure that securitised exposures are not substandard in terms of the process under which they were underwritten. The objective is not to homogenise credit-granting standards beyond the point of appropriate flexibility; therefore, the requirement does not mean that the actual borrower types or loan products for securitised and non-securitised exposures must be the same, just that the credit-granting process for extending such loan products to borrowers must be the same for both securitised and non-securitised exposures.²³ For instance, a credit institution may grant credit to borrowers through a number of distinct subsidiaries or related entities. In such circumstances, it would not typically be expected that the criteria for credit-granting be identical in all such subsidiaries or related entities; rather, it would be expected that within each subsidiary or related entity the same

²³ However, when the “on balance sheet” option (c) of Paragraph 1 is used to fulfil the retention requirement, then this clause must be interpreted in conjunction with both the intention of removing any misalignment of interest and the guidelines on ensuring randomness in selection of securitised versus non-securitised exposures under clause 50.

criteria for credit-granting be applied to both securitised and non-securitised exposures, and that such criteria be sound and well-defined.

115. While securitised exposures must benefit from the same sound and well-defined credit-granting criteria, this does not mean that such criteria must be identical in all respects. For example, there may be aspects of the underwriting process for specific loan products that might specifically have to be added or removed in order to meet the conditions for sale of such underlying loans to the securitisation that a lender would not necessarily apply to loans that it intends to retain on its own balance sheet.
116. While a sponsor or originator credit institution should apply the same sound and well-defined criteria to both securitised and non-securitised exposures, in cases where securitised exposures consist of exposures where credit-granting was initially made by an unconnected originator, sponsor or original lender (not the originator or sponsor credit institution itself), then the application of these same sound and well-defined criteria may, by necessity, be undertaken with more limited scope of information than would be the case if the originator or sponsor credit institution had itself initially granted credit. Nonetheless, such originator or sponsor credit institution should make its best effort to obtain all necessary information to perform a sound due diligence on the exposures to be securitised.
117. When a credit institution acting as sponsor or originator is not active in credit-granting in the specific types of exposures that are being securitised, then it may not be possible for it to apply the “same” sound and well-defined criteria for credit-granting that it applies to exposures held on its book, as they are of a different exposure type. However, in such circumstances the credit institution acting as sponsor or originator of such securitisation should instead have sufficient understanding to assess – and undertake such assessment of – whether the criteria for credit-granting of the exposures to be securitised can be considered to be sound and well-defined, without specific reference to the credit institution’s own criteria for credit-granting. This could be the case, for instance, should a credit institution that is not active in credit-granting for auto loans act as sponsor of an auto loan securitisation.
118. It is recognised that credit institutions, when acting as the sponsors and originators of certain securitisations (such as ABCP conduits), do not themselves typically undertake the credit approval process in respect of the exposures being sold into such securitisations (this is typically done instead by the originators or original lenders of the underlying exposures), nor are such credit institutions expected to subject such exposures to their own credit approval processes (either on an individual or aggregate basis). It is also recognised that the credit issuance standards of such originators or original lenders may deviate from those of the credit institution. Nonetheless, the broader provisions of Paragraph 6 – i.e. ensuring that the criteria for credit-granting are sound and well-defined and that this is equally the case for both securitised and non-securitised exposures – still apply in such circumstances.

Participations and underwritings

119. Pursuant to Paragraph 6, credit institutions are required to apply the same standards of analysis to participations or underwritings in securitisation issues purchased from third parties whether such participations or underwritings are to be held in their trading or non-trading book. This denotes that when a credit institution is part of a syndicate or similar group underwriting the issuance of a securitisation (for instance, when such securitisation is backed by receivables purchased from a third party), such credit institution shall apply the same standards of analysis notwithstanding the purchased nature of such securitisations, and regardless of whether such securitisations are held in the trading or the non-trading book (and even if the duration of exposure is brief, e.g. during the underwriting period).

Other issues

120. On the distinction between the trading and non-trading book referenced in Paragraph 6, see also the guidance provided under Paragraph 4.

Paragraph 7

Paragraph 7

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

General considerations

121. For an overview of how the provisions of Paragraph 7 apply with respect to the various roles a credit institution can assume in a securitisation, and how these in turn can be mapped to the application of sanctions for non-compliance with the provisions of Paragraph 7, see the section “Considerations on Paragraphs 1-7” above.²⁴
122. The guidance provided on the depth, breadth and frequency of analysis required by investors detailed under Paragraph 4 equally applies as guidance in respect of the disclosures required by sponsor and originator credit institutions. Furthermore, an originator or sponsor can fulfil the obligations outlined under Paragraph 7 by ensuring that (for example) standardised reporting and disclosure templates, generally accepted by market participants, are used, assuming such templates fulfil these requirements adequately.

Disclosing the retained interest

123. In fulfilling their requirement to disclose “the level of their commitment under Paragraph 1 to maintain a net economic interest in the securitisation” under Paragraph 7, sponsor and originator credit institutions should also indicate which of options (a) through (d) in Paragraph 1 has been used in retaining such net economic interest. Should, due to exceptional circumstances, the form of retention (i.e. which of options (a)-(d) in Paragraph 1 has been chosen) change during the life of the transaction (on which, see paragraph 32), this must also be disclosed.

²⁴ It is recognized that, in practice, the obligation of a credit institution as sponsor and originator to disclose the information outlined in Paragraph 7 may be an indirect obligation, as the direct obligation may be upon another entity (for instance, the securitisation issuer or trustee) to make such disclosures to investors, while this other entity may ultimately rely upon such credit institution (in its role as sponsor or originator) to provide this information. This does not relieve a credit institution in its role as sponsor or originator of its duty to fulfil the requirements of Paragraph 7.

124. In fulfilling the requirement to disclose “the level of their commitment under Paragraph 1 to maintain a net economic interest in the securitisation” under Paragraph 7, the obligation of a sponsor or originator credit institution is to disclose that it continues to fulfil the obligation that it initially undertook to maintain such net economic interest in the securitisation. The obligation does not extend to the sponsor or originator credit institution providing further information with respect to the current nominal value, current market value, or any impairments or write-downs on such retained interest.

Disclosing materially relevant data and information

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

126. The term “securitisation exposure” in Paragraph 7 could, in certain cases, be better read as “securitisation position”, and the term “collateral” in Paragraph 7 could, in certain cases, be better read as “securitised exposures”.

127. The term “readily available” means that gaining access to the information should not be overly prohibitive (in terms of search, accessibility, usage, cost and other factors that might impede availability), so that fulfilling their due diligence requirements is not overly burdensome on investors.

128. The term “individual underlying exposures”, for which relevant data must be provided by credit institutions as sponsors or originators, will typically mean that such data should be provided on an individual exposure (or “loan-level”) basis, as opposed to on a collective basis. However, it is recognised that there may be circumstances in which such loan-level disclosure is not appropriate; for instance, securitisations with a large volume of exposures that are highly granular. On the other hand, in many circumstances loan-level disclosure is a material necessity for the due diligence process; for instance, securitisations with large concentrations of non-granular exposures. In determining whether such information should be provided on an individual or aggregate basis, a credit institution, when acting as originator or sponsor, should consider the information that a credit institution when acting as investor would need in order to fulfil its requirements under Paragraphs 4 and 5.

Scope delimitation in fulfilling disclosure requirements

129. The disclosure requirements of credit institutions when acting as sponsors or originators of securitisations, as outlined in Paragraph 7 above, need not extend to the provision of information that would directly or indirectly breach other legal or regulatory requirements of such credit institutions (for

instance, market abuse and confidentiality restrictions, including (but not limited to) those related to clients and customers).

Paragraph 8

Paragraph 8

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

General considerations

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

“Existing” and “new” securitisations

131. For the purposes of Paragraph 8:

- (i). the term “existing” means those securitisations that came into existence before 1 January 2011;
- (ii). the date on which a credit institution assumed exposure to, or invested in, such securitisation is irrelevant; and
- (iii). the term “that date” means 31 December 2014.

Date of existence of securitisation scheme or program (Not date of acquisition of position or assumption of exposure)		Do Articles 1-7 of Article 122a apply?
Before 01-Jan-11 (“Existing securitisation”)	No addition/ substitution of exposures at any time	No
	New exposures added/substituted after 01-Jan-11, but not after 31-Dec-14	No
	New exposures added/substituted after 31-Dec-14	Yes, applies after 31-Dec-2014
On or after 01-Jan-11 (“New securitisation”)		Yes, applies immediately

Accordingly:

- (i). Securitisations that came into existence prior to 1 January 2011, which never add or substitute new underlying exposures at any time thereafter, shall not be subject to Paragraphs 1-7.

- (ii). Securitisations that came into existence prior to 1 January 2011, which add or substitute new underlying exposures only up to 31 December 2014, shall not be subject to Paragraphs 1-7.
- (iii). Securitisations that came into existence prior to 1 January 2011, which add or substitute new underlying exposures at any time after 31 December 2014, shall become subject to Paragraphs 1-7 when such underlying exposures are first added or substituted after 31 December 2014.
- (iv). Securitisations that come into existence on or after 1 January 2011 will all be subject to Paragraphs 1-7 on and from the date they come into existence.

132. Use of the term “existing securitisations” in Paragraph 8 means whether or not the securitisation program or scheme exists or not at the reference points in time, and does not mean whether or not individual liabilities of the securitisation program (for instance, bonds in issuance) exist or not at the reference points in time. By extension, where the liabilities of an existing securitisation continue to revolve, but the assets that support such liabilities cease to revolve (i.e. there are no “new underlying exposures”, as per Paragraph 8), this does not in itself cause the provisions of Paragraphs 1-7 to become applicable to such securitisation. In summary, it is changes in the assets, and not changes in the liabilities, of an existing securitisation that determine whether or not it becomes subject to the provisions of Paragraphs 1-7 of Article 122a. With respect to the application of this clause, competent authorities will pay specific attention to securitisation programs or schemes established in late 2010.

Substitution of exposures

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

134. The addition or substitution of new exposures does not include circumstances in which:

- (i). the underlying obligor of an existing securitised exposure has not changed (for instance, a mortgage loan borrower switching from one loan product to another, or a commercial real estate loan in which there has been a change of underlying rental agreement, lease, or tenant);
- (ii). only the legal or ownership status of the obligor of an existing securitised exposure has changed (for instance, an obligor entity has undergone an amalgamation, merger, consolidation, restructuring, or change of legal form – for instance, from a limited liability company to a limited liability partnership);
- (iii). there is substitution of one exposure with another exposure for very specific pre-defined contractual reasons pursuant to the original terms of such securitisation (for instance, due to breach of the representations and warranties made upon sale of loans to such securitisation by the originator or original lender);

- (iv). there is repurchase of an exposure with cash, due to reasons similar to those outlined in (iii) above (for instance, due to a breach of the representations and warranties made upon sale of loans to such securitisation);
- (v). The maturity of an existing exposure is extended, albeit without such exposure being replaced by a new exposure (for instance, a commercial real estate loan is extended or restructured at maturity, but without replacing the prior loan agreement with a new loan agreement);
- (vi). There is a change in the size of an existing exposure due to increased utilisation of the available facility (for instance, in the case of credit card loans with revolving balances, where the borrower chooses to further draw down his/her available balance).

Events of this nature (this is a non-exhaustive list) would not cause the provisions of Paragraphs 1-7 to apply to a securitisation.

Other issues

135. In cases where a securitisation scheme has multiple discrete pools of exposures, should any one of these add or substitute new exposures, the scheme or program as a whole will become subject to the provisions of Paragraphs 1-7. Furthermore, should a new discrete pool of exposures be added to the existing exposure pools of such a scheme, then the fact that the scheme as a whole has now become subject to the provisions of Paragraphs 1-7 could, therefore, impact the other exposure pools in such scheme also (and by extension, the originators or original lenders thereof), even if those other pools have ceased to add or substitute new underlying exposures. To give one specific example, in the case of a multi-seller ABCP conduit, should there be one originator or original lender (i.e. seller of receivables into the conduit) that continues to add or substitute new exposures (even though all other originators or original lenders have ceased to do so), or should there be one new originator or original lender adding exposures to such conduit for the first time (even though all other existing originators or original lenders have ceased to add or substitute new exposures), such conduit would nonetheless become subject to the provisions of Paragraphs 1-7 in its entirety, and all originators and original lenders in such conduit (i.e. the multiple sellers of discrete pools of receivables) may be impacted thereby.²⁵

136. As outlined above, Paragraphs 1-7 will apply to securitisations that existed on or before 1 January 2011 if new underlying exposures are added or substituted after 31 December 2014, even if such positions were acquired or such exposures assumed by a credit institution prior to 1 January 2011, However, when competent authorities determine whether additional risk weights are appropriate for infringements in accordance with Paragraph 5, account may be taken of whether there is "negligence or omission of the credit institution" or whether the requirements are not being met "in any material respect" (as also specified in such paragraph). There may be circumstances in which a credit institution is unable to fulfil (and could not have foreseen in advance the need to fulfil) the requirements of Paragraphs

²⁵ However, see also clause 15 on requirements where securitisation vehicles have multiple discrete underlying transactions.

1-7 for positions acquired or exposures assumed before 1 January 2011, and this may be taken into account.

137. By extension, if a credit institution has already assumed exposure to the credit risk of a securitisation position prior to 1 January 2011, and the originator, sponsor or original lender has not explicitly disclosed that it will fulfil the retention requirement (as per Paragraph 1), even though new exposures are to be added or substituted in the securitisation after 31 December 2014, the additional risk weights specified by Paragraph 5 could be imposed by the competent authority after 31 December 2014; however, this is subject to the considerations outlined in clause 136 above, i.e. assuming that such non-fulfilment of the requirements of Paragraph 1 involves negligence and omission of the credit institution and is material. For positions acquired or exposures assumed before 1 January 2011, this may not necessarily be the case, and it is recognized that there may be circumstances in which it is not possible for the retention requirement to be fulfilled retrospectively with respect to such positions.²⁶ For such reasons, competent authorities may, under certain circumstances, assess the nature and materiality of non-fulfilment of Paragraph 1 for those positions and exposures acquired or assumed prior to 1 January 2011 differently to those acquired and assumed after 1 January 2011.

²⁶ For instance: the originator, sponsor or original lender may no longer exist; the contractual documentation underlying the securitisation may not envisage or allow for the originator, sponsor or original lender assuming an interest in such securitisation (for instance, due to potential conflicts of interest); other holders of positions in the same securitisation may not allow (via voting rights) the originator, sponsor or original lender to assume an interest in such securitisation; other holders of positions in the same securitisation may prefer (via voting rights) that the securitisation continue to add or substitute new exposures in spite of the lack of a retained interest by the originator, sponsor, or original lender. This is a non-exhaustive list for illustrative purposes only.

Paragraph 9

Paragraph 9

Competent authorities shall disclose the following information:

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

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

General considerations

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

Paragraph 10

Paragraph 10

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

General considerations

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