

This article originally appeared in the August 1, 2008 issue of *White & Case Structured Finance Bulletin*.

Impact of Possible Regulatory Changes to European Capital Requirements Directive (CRD) on Originate-to-Distribute Model

Dr. Dennis Heuer and Daniel Baierlein
White & Case LLP, Frankfurt

The pooling of loans and loan portfolios and transferring credit risk from originating banks to investors by way of securitisation is widely recognised as an essential pillar to the stability of the capital markets. This was often forgotten by the public and even market participants when securitisation and structured debt obligations were blamed in the aftermath of the credit crisis that emerged mid 2007. On the other hand, it is true that many lending banks have made excessive use of the Originate-to-Distribute Model, having systematically offloaded their high risk loans to investors immediately after origination instead of retaining them on their balance sheets. The repackaging of these high risk loans with higher quality loans into collateralised debt obligations with partially higher credit ratings then surprised investors in the current market turmoil with unexpected losses.

The European Commission now has proposed certain regulatory changes, some of which will restrict the regulatory incentives for originating banks to transfer all risks of a securitisation to investors. The rationale for such restrictions was that originating

Banks should remain exposed to the underlying assets of the securitisation so that their incentives would be more aligned with those of investors in order to avoid excessive and unsound levels of risk transfer as seen in the past and, ultimately, lead to better credit quality loans being originated. The European Commission issued a working document on possible changes to the Capital Requirements Directive (CRD) (2006/48/EC and 2006/49/EC) on 16 April 2008 for discussion and consultation purposes with the industry and other stakeholders. It is envisaged that the legislative procedure on EU level will be completed by spring 2009. This will be followed by EU Member State implementation of the CRD through their national laws. In the original consultation paper, the Commission introduced, inter alios, a quantitative requirement for originating banks of securitisations to hold capital for at least 15% of the securitised exposures, regardless of the securitisation positions actually retained (the "15% floor-requirement"). Furthermore, and as a qualitative draft requirement aiming to achieve the same result, the Commission



Dr. Dennis Heuer
Local Partner



Daniel Baierlein
Associate

suggested that originating banks should be required to apply the same due diligence in their lending decisions, irrespective of whether or not their loans are securitised.

The consultation process revealed particular concerns about the 15% floor-requirement for a number of reasons, including the following: (i) the requirement is not risk-sensitive and (ii) the requirement penalises CRD-regulated originators when compared to non-European originators and European non-bank originators. The Commission subsequently abandoned the 15% floor-requirement in a second consultation paper at the end of June. Instead the Commission suggested that the (bank) investors – irrespective of whether they are EU banks or not - must ensure that they invest only in credit risk transfer products if the originators or, alternatively, the distributors (e.g. sponsors/arrangers) explicitly commit themselves to retain some exposure (10%) of the credit risk (the “10% floor-requirement”).

It is, however, not clear what the basis for the 10% floor-requirement should be. The draft refers to maintenance of “a net economic interest of in sum at least 10% in positions having the same risk profile as the one that the [investor] credit institution is exposed to”. The wording leaves room for interpretation. “Positions having the same risk profile” suggests that the originator or sponsor would need to remain exposed to 10% in each of the transferred tranches of the securitisation. As far as the most senior tranche of the securitisation is concerned, one could doubt whether the risk-sharing in such risk position really serves the overall aim of the proposed amendments to the CRD. The senior tranche is less likely to be subject to losses due to the structural priority and thus by holding such tranche the originator will less likely be hit by losses which in turn could incentivise more stringent credit policies when originating. The result of the 10 % floor-requirement would then be that funding costs will increase without, at the same time, achieving the overall aim of improving the

credit quality of the securitised loans. Additionally, the concept of retaining risk on a tranche-by-tranche basis may conflict with the requirements of a significant risk transfer under the German Solvency Ordinance (Solvabilitätsverordnung). The German implementation of Basle II and the CRD requires that the originator transfers more than 50% of all mezzanine positions in the securitisation in order to achieve off-balance sheet treatment for regulatory purposes.

The new draft Article 122a CRD proposes, rather ambiguously, that the investor “shall only be exposed to the credit risk” if the originator fulfils the 10% floor-requirement. The wording could either mean that the credit risk transfer is considered to be void or that the investor and/or the originator face other detrimental legal effects.

The draft itself does not specify the consequences. Thus the question arises what happens if the originator’s exposure is below the 10% floor-requirement. The Commission’s rationale suggests that the investors “should ensure that they invest only in credit risk transfer products” if the originators and distributors of the credit risk retain some exposure themselves. It seems that the Commission does not intend to prohibit but simply disincentivise (European) investors from investing in products that do not fulfil the 10% floor-requirement. An enquiry with the EU Commission has revealed that specific legal consequences have intentionally not been stipulated so that, pursuant to Article 136 CRD, national authorities would be entitled to react and therefore consequences would be specified on a national level.

In light of this proposal, it may be that Member States will compete against each other when implementing the CRD into national law. Different degrees of implementation will not lead to the required minimum harmonisation within the EU. Furthermore, the Commission states that the 10% floor-requirement applies to originators

Impact of Possible Regulatory Changes to European Capital Requirements Directive (CRD) on Originate-to-Distribute Model

and distributors irrespective of whether or not they are EU banks. Even if, at first sight, the CRD appears to target investors only, it also introduces the 10% floor-requirement for non-EU banks and non-European originators through the backdoor. One might question whether this approach to extend European regulations to Non-European banks and Non-European originators exceeds the legislative competence of the EU.

Nevertheless, the proposed retention of a minimum capital charge in relation to a securitised portfolio is a justified response to the current subprime crisis and excessive lending in the USA and should lead to greater risk sensitivity. By holding the lenders responsible for the credit risk they originate, the Commission hopes to promote financial stability. Market participants must now wait to find out what will be the results of the consultation process on the 10% floor-requirement. Meanwhile, the (European) legislator must find the right balance between over-regulation and under-regulation. It may also be more sensible to introduce regulation under the auspices of the Bank for International Settlements (BIS) to prevent a global competitive disadvantage for European banks. In our view, only economically acceptable, clear and reliable guidance will guarantee the level of confidence required by the banks when considering the use of securitisation to achieve off-balance sheet treatment for regulatory purposes in the future.

Dr. Dennis Heuer is Local Partner in the Frankfurt office of White & Case. He specializes in structured finance, securitization and distressed debt.

Daniel Baierlein is Associate in the Frankfurt office of White & Case. He specializes in structured finance, securitization and distressed debt.

The information in this article is for educational purposes only; it should not be construed as legal advice.
