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European Commission
DG Internal Market and Services

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Incentives in the originate-to-distribute model
Draft new Article 122a for Directive 2006/48/EC

Dear Madam, dear Sir,

In its letter of 1 July 2008 the European Commission unveiled new draft requirements aimed at ensuring appropriate incentives in the originate-to-distribute model and invited comments by 18 July 2008. We welcome this opportunity to respond to the Commission's proposal and set out the position of the German banking industry below.

First and foremost, we welcome the fact that the Commission has taken on board the European banking industry's concerns about the 15% minimum capital charge for securitised assets proposed in its recent consultation paper and has decided to explore alternative arrangements. In place of the envisaged addition to Article 95(2) of Directive 2006/48/EC, the Commission is now proposing to introduce a new Article 122a imposing restrictions on the opportunities of investing in risk transfer products. Banks (along, possibly, with insurance companies and UCITS funds) would only be permitted to invest in securitisations or other risk transfer products if the originator or manager of the transaction retained a "net economic interest" of at least 10% in positions with the same risk profile as that of the securitised assets in question.

. . .

The German banks firmly reject this alternative proposal. It constitutes excessive interference in the business of the European banking industry and, even in light of the recent financial turmoil, lacks all justification. It should, in particular, be borne in mind that the vast majority of problems with the securitisation of loans not previously subject to adequate risk management were experienced by companies outside the EU and were confined to specific loan segments. Moreover, a ban on investing in certain securities flies in the face of basic principles of the market economy and of banking supervision in the EU.

In addition, the wording of Article 122a might have disproportionate effects which cannot be justified by the objective of the proposed new rules:

a) Application to risk transfer products other than securitisations
We reject the envisaged application of the rules also to other forms of risk transfer, above all credit derivatives and syndications. This would radically reduce the banks' ability to transfer risk because it would no longer be possible, for example, to fully syndicate consortium loans or transfer credit risk by means of credit derivatives although there is no evidence to date linking these risk transfer mechanisms with adverse incentives. Furthermore, we see no need to give special protection to the members of a lending syndicate or sellers of credit derivatives. These investors have full transparency about the associated risks as a result of the disclosure of the loan agreements to all syndicate banks, for instance. There is a further problem with credit derivatives because it is impossible to make a clear distinction between their use to transfer risk between banks and own-account trading in these instruments. The proposed rule could result in the own-account division having to be informed about the amount of credit extended by the bank. This is in breach of rules on banking secrecy, insider trading and compliance.

In terms of structure, documentation and distribution channels, moreover, syndicated loans and credit derivatives are not comparable with securitisation products.

b) Unclear definition of "investor"
The wording could also cover transactions in which the bank acts as an investor or liquidity provider in an ABCP multi-seller conduit, for example, but where the underlying assets are not typical bank assets but were securitised on behalf of the customer for corporate financing purposes (e.g. trade receivables). This would go beyond the Commission's objective, namely to bring about an alignment of the banks' internal lending practices for

securitised and unsecuritised loans, because the type of transaction outlined above does not correspond to the originate-to-distribute model.

On top of this, Article 122a would place the European banking industry at a competitive disadvantage. Banks in non-EU countries and unregulated companies could continue to invest in the products at issue without restrictions. The upshot would be the emergence in the EU of a more costly and complex "second market" while non-European players could operate in the "original market" on more favourable terms. Furthermore, originators could circumvent the rules by placing their transactions outside the EU, which would run counter to the intention of the proposed requirement.

Leaving aside our general concerns about the new proposal, we foresee a number of practical problems and uncertainties regarding its technical implementation:

- First of all, it is not clear exactly which positions the originator would have to retain in order for an investor to be allowed to invest in a risk transfer product. The Commission proposes that these should have the "same risk profile" as that of the positions held by the investor. There is a need to clarify how "risk profile" is to be interpreted in the context of a securitisation transaction. Furthermore, a feature of positions in a securitisation transaction is that their risk profiles differ. It is also unclear how sponsors which have furnished guarantees for an ABCP programme are supposed to comply with the rule.

- Nor is it clear how to interpret "net economic interest", which is to form the basis for calculating the amount of positions to be retained.

- The proposal envisages that the originator should issue an "explicit commitment" to the investing bank that it will maintain a net economic interest of at least 10% in the positions in question. This would pose significant problems for both originators and investors. The information about securitisation products generally available in the market provides no indication of which positions are retained by originators/sponsors. Issuing explicit commitments would consequently involve a not inconsiderable amount of additional bureaucracy for originators. In addition, every investment in a securitisation position would require the investor to verify whether the originator/sponsor had duly retained the correct amount of exposure. This is also likely to generate substantial costs. The requirement could result in the already modest number of investors in risk transfer products becoming smaller still. If the original investor then sold the assets to a secondary investor, the situation would

become even more complicated. Since the originator would in many cases not know the new investor, the new investor would have to approach the originator and request it to issue a new commitment. The secondary market, which plays an important role in pricing, would probably come to a virtual standstill throughout Europe.

- The originator/sponsor will be required to retain 10% of the positions throughout the entire life of the transaction. It is not clear what the implications would be for the investor in the event that the requirement was met at the time of acquisition, but no longer satisfied at some later date. Would the investor have to sell the assets? The same problem arises with regard to paragraph 3(b) if there is a change in the rating of a bank acting as a debtor/guarantor. Furthermore, the rule sets an adverse incentive since the retention requirement would induce a false sense of security and might cause investors to monitor their investments in risk transfer products less stringently.

- Competent authorities are to be able to suspend the rule in "periods of general market liquidity stress". How is such a period to be defined? The question also arises as to how it can be ensured that competent authorities apply paragraph 5 in a consistent manner throughout Europe.

- Owing to the capital charges associated with the compulsorily retained positions, there is a risk that smaller market participants might no longer be sufficiently well capitalised and would no longer be able to operate in the market. This would also have an adverse effect on market depth.

- The retention requirement also places a radical constraint on the banks' ability to practise active risk management. They would no longer be able to respond appropriately to adverse market movements but would be obliged to hold on to their exposure.

- Last but not least, we would like to draw attention to the potential tension between the retention requirement and the rules on significant risk transfer in Annex IX, Part 2.

For the reasons outlined above, we consider the proposed requirement wholly inappropriate and impracticable.

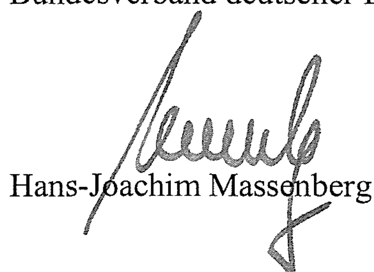
Like the initially proposed introduction of a 15% minimum capital charge for securitised exposures, Article 122a aims at creating incentives to applying sound and appropriate lending

practices when exposures are destined for securitisation. It is also intended to ensure better monitoring of the risks associated with positions in the secured portfolio. In our view, weaknesses in lending and risk management practices should be addressed in Pillar 2. The planned additional requirements for managing the risks associated with securitisations in Annex V of Directive 2006/48/EC point in the right direction. The suitability of the banks' implementation of Pillar 2 is regularly monitored both internally and by the competent authorities.

The proposed new rule, by contrast, would do nothing to promote the application of better, more effective practices by investors in securitisation positions. Here too, the amendments to Annex V of Directive 2006/48/EC take a more appropriate approach. All in all, we would ask the Commission to refrain from a knee-jerk response to concerns about securitisation transactions. We believe it is important to continue to carefully analyse the causes of the current crisis and consult with securitisation experts before issuing further rules. It is in the interests of the banks themselves to develop rules and recommendations capable of eliminating the shortcomings which became apparent during the financial turmoil. Increasing transparency has a key role to play in this respect.

We would naturally be pleased to discuss any issues raised in these comments at any time.

Yours sincerely
on behalf of the Zentraler Kreditausschuss,
Bundesverband deutscher Banken



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