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A legal update from Dechert's Finance and Real Estate Group

European Commission's Second Public Consultation Paper on Possible Changes to Capital Requirements Directive

The European Commission recently published its Second Public Consultation Paper (the "Second Public Consultation Paper") on Possible Changes to the Capital Requirements Directive (consisting of Directives 2006/48/EC and 2006/49/EC), which served to propose an alternative to the much-criticized requirement in the European Commission's First Public Consultation Paper (the "First Public Consultation Paper") that originators of securitizations hold capital for at least 15% of the securitized exposures even if they were entirely sold in order to reduce the incentives for originators to transfer all risks of a securitization to investors. Comment letters on the First Public Consultation Paper focused on the fact that such a requirement would be ineffective and would place European Union (EU) banks at a competitive disadvantage in the global capital markets.

The main changes proposed in the Second Public Consultation Paper were directed at EU banks acting as investors, rather than originators or distributors, and were intended to address level playing field concerns, exclude structuring arbitrage, and provide for more flexibility. As reflected in proposed new Article 122a, these goals were to be achieved by shifting the risk-retention requirement from the EU bank to originators and distributors wherever located by broadly covering the universe of risk-transfer products and by allowing originators and sponsors/arrangers to decide how to allocate the exposure retained in a particular transaction.

The most important of these changes was that, instead of requiring banks acting as originators to set aside capital for at least 15% of the securitized exposures, the new proposal would require banks acting as investors to ensure that they invest only in credit risk transfer products if the originators and sponsors/arrangers of the credit risk retain at least 10% of the exposure themselves. The European Commission hoped this reallocation and reduction of the risk-retention requirement would address the earlier concerns of EU institutions with regard to competitive disadvantage, i.e., under the revised proposal, non-EU institutions would have to retain 10% of the exposure in order to sell to EU investors. The full text of proposed Article 122a appears at the end of this update.

The deadline for contributions on the Second Public Consultation Paper was July 18, 2008. Reaction to the proposals was critical. Commenters criticized the expansion of the scope of the proposed amendments in that they would apply to any credit risk transfer

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Proposed New Article 122a

1. A credit institution shall only be exposed to the credit risk of an obligation or potential obligation or a pool of obligations or potential obligations where it was not involved in directly negotiating, structuring, and documenting the original agreement which created the obligations or potential obligations if the persons or entities

(a) that directly negotiated, structured, and documented the original agreement with the obligor or potential obligor; or alternatively and where applicable

(b) the persons or entities that manage and purchase such obligations or potential obligations directly or indirectly on behalf of the credit institution have issued an explicit commitment to the credit institution to maintain, on an ongoing basis, a net economic interest of in sum at least 10% in positions having the same risk profile as the one that the credit institution is exposed to.

2. Paragraph 1 shall reply regardless of whether the credit institution is exposed directly or indirectly due to a securitization, credit derivative, syndication, or other risk transfer mechanisms.

3. For the purposes of paragraph 1, obligations or potential obligations shall not include claims or contingent claims on or guaranteed by

(a) central governments or central banks;

(b) institutions to which a credit quality step of 3 or better applies according to Annex VI, Part 3, point 29; and

(c) multilateral development banks.

4. Paragraph 1 shall only apply to exposures incurred by the credit institution after 1 January 2011.

5. Competent authorities may decide to temporarily suspend the application of paragraph 1 during periods of general market liquidity stress.

instrument—e.g., in addition to securitized products, derivatives and loan purchases would also be implicated. As the Loan Syndications and Trading Association noted in their comment letter, "[w]ere the 10% retention rule on buyers of loans to be adopted, European banks would effectively be precluded from continuing to participate in [large syndicated loan] transactions (since originators of syndicated loans in the United States will likely not . . . agree to the 10% retention requirement). Besides putting European banks at a distinct disadvantage, the effect of the proposal would be to constrain the amount of capital available to the syndicated loan market in the United States (at a time when the markets can ill afford any further drain on liquidity)." Capital market participants were also uncomfortable with investors having to bear the burden of monitoring compliance with the 10% retention requirement. Some respondents raised concerns about the timing of the proposed changes given that the Basel Committee is still working on related measures. In addition, commenters raised moral hazard concerns due to the fact that investors may place undue reliance on the 10% retention requirement and fail to perform the necessary due diligence prior to investing.

Following consideration of the contributions received, the European Commission plans to issue an amending directive in September 2008 for adoption by the European Council and the European Parliament.

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