News Bulletin

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CRD3 Changes to Trading Book, Re-securitisations and Securitisations Disclosure

On 14 December 2010, the final text of the Directive amending the Capital Requirement Directive ("**CRD**") as regards capital requirements for the trading book and for re-securitisations and the supervisory review of remuneration policies (known as "**CRD3**") was published in the Official Journal of the European Union ("**EU**").[1] CRD implements in the EU the international framework for capital requirements of banks or credit institutions which are recommended by the Basel Committee on Banking Supervision ("**BCBS**"). CRD3 forms part of a series of amendments to the CRD initiated by the European Commission (the "**Commission**") in response to the financial crisis.

In this client alert, we summarise the key changes to the rules relating to the treatment of the trading book, re-securitisations and disclosures relating to securitisations under CRD3. CRD3 also introduces requirements for banks to implement remuneration policies that are consistent with their long-term financial results and do not encourage excessive risk-taking. For example, in relation to variable remuneration (aka, bonuses), at least 40% must be deferred for three to five years and at least 50% must consist of shares, share-linked instruments or long-dated instruments that are convertible into Tier 1 capital during emergency situations. We will cover the details of the remuneration provisions of CRD3 in a separate client alert.

Re-securitisation

The Commission agrees with BCBS that re-securitisations involve higher risks than normal securitisations, due to the added layer of complexity and sensitivity to correlated losses. Therefore, CRD3 increases the capital requirements for banks investing in re-securitisations. In particular, for the same "credit quality step" (i.e., credit rating grade), re-securitisation positions will receive a higher risk weight than securitisation positions.

However, the final text of CRD3 does not include the more stringent due diligence requirements for "highly complex re-securitisations", which the Commission had initially proposed in July 2009.[2] In a report dated 28 June 2010, the Economic and Monetary Affairs Committee of the European Parliament recommended against the introduction of such requirements pending the Commission's report on the impact of Article 122a of the CRD (which requires the originating bank to retain at least 5% of the securitisation exposure).[3]

[1] Directive (2010/76/EU) of 24 November 2010 amending the Capital Requirements Directive (2006/48/EC and 2006/49/EC) as regards capital requirements for the trading book and for re-securitisations and the supervisory review of remuneration policies, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:329:0003:0035:EN:PDF.

[2] European Commission's Proposal to amend CRD for trading book, re-securitisations and remuneration policies (13 July 2009), http://ec.europa.eu/internal_market/bank/docs/regcapital/com2009/Leg_Proposal_Adopted_1307.pdf.

[3] European Parliament Economic and Monetary Affairs Committee Report on the proposal for a directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the

CRD3 defines a "re-securitisation" as a securitisation where the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation position. A re-securitisation position is any exposure to a re-securitisation.

The definition is very broad and care will need to be taken in structuring transactions to ensure that they are not treated as re-securitisations under CRD3 and therefore subject to the increased risk weighting. The definition clearly catches CDOs of ABS, but will also cover any tranched deal where the pool includes any RMBS or CMBS security or other securitisation exposure. It will also catch any credit derivative which provides credit protection for a re-securitisation exposure.

The definition of re-securitisation raises particular issues in relation to asset-backed commercial paper ("**ABCP**") programmes. Guidance previously published by BCBS states that a liquidity facility to an ABCP programme should generally not be a re-securitisation position, provided it covers 100% of the assets, is a single tranche and none of the assets in the pool is a re-securitisation position. A programme-wide credit enhancement facility which covers only some loss across the pool of assets in the programme would be a tranching of risk and therefore would be a re-securitisation position. The guidance states that commercial paper issued under an ABCP programme should not be regarded as a re-securitisation, provided there is a single tranche of commercial paper and the programme-wide credit enhancement is not a re-securitisation or the commercial paper is fully supported by the sponsoring bank so that the external rating of the commercial paper is based primarily on the credit quality of the sponsor.

Under the new re-securitisation rules, comparative risk weightings for the standardised approach in respect of the long-term rating of the relevant security are as follows:

Rating	**Securitisation exposures**	**Re-securitisation exposures**
AAA to AA	20	40
A+ to A-	50	100
BBB+ to BBB-	100	225
BB+ to BB-	350	650
B+ and below or unrated	Deduction	Deduction

Disclosure of securitisation risks

Currently, the disclosure obligation for securitisation risks only covers information relating to such risks on the banking book. CRD3 extends the disclosure obligation to the trading book. In addition, all securitisation activities with banks sponsoring any securitisation special purpose entity ("**SSPE**") must be disclosed and broken down by whether they are on- or off-balance sheet exposures.

CRD3 sets out detailed requirements in relation to information which must be disclosed separately for the trading book and the banking book, including:

- the bank's objectives in relation to securitisation activity;
- the nature of other risks, including liquidity risk inherent in securitised assets;
- the processes in place to monitor changes in the credit and market risks of securitisation exposures;

trading book and for re-securitisations, and the supervisory review of remuneration policies (28 June 2010), http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A7-2010-0205&format=XML&language=EN.

- the bank's hedging policy concerning retained securitisation and re-securitisation exposures (including the identity of material hedge counterparties);
- the bank's approaches to calculating risk-weighted exposure amounts;
- the types of SSPE used by the bank as sponsor;
- the bank's accounting policies for securitisation activities; and
- the aggregate amount of securitisation/re-securitisation exposures, broken down by traditional and synthetic securitisations.

Trading book

To ensure that banks' assessments of their trading book risks reflect potential losses from deteriorating market conditions, CRD3 strengthens the capital requirements in relation to the trading book as follows:

▪ ***Incremental risk charge ("IRC"):*** A new IRC will be applied to banks with approval to model "specific risk" (i.e., of price changes due to issuer-related factors) in the trading book. Replacing the current incremental *default* risk charge, the IRC is designed to capture the migration risk (i.e., of direct or indirect loss due to an internal or external ratings change or a credit migration event) as well as the default risk.

Subject to approval by the supervisor, CRD3 will permit banks to use estimates of the probability of default and loss given default derived from the IRC approach, provided that those estimates comply with the quantitative standards for the internal ratings-based ("**IRB**") approach. CRD3 also permits banks to use an approach for capturing incremental default and migration risks which does not comply with all the criteria under CRD3, provided that it does not result in a lower capital requirement.

CRD3 mandates the Committee of European Banking Supervisors ("**CEBS**") to develop guidelines to ensure convergent use of the P/D and LGD estimates based on the IRC and to monitor banks' use of any approach for capturing incremental default and credit migration risks which does not comply with the CRD3 criteria and develop relevant guidelines.

▪ ***Stressed value-at-risk ("VaR")*:** Banks using VaR modelling must, in addition to the VaR measure, calculate a "stressed VaR" capital charge each week, based on historical data from a continuous 12-month period of significant financial stress. CRD3 mandates CEBS to monitor member states' practices in relation to supervisory approval for banks' choice of historical data in calculating the stressed VaR, so as to ensure consistent implementation.

▪ ***Securitisation positions*:** To address potential arbitrage between the trading book and the banking book, CRD3 equalises the (currently lower) capital charges for securitisations in the trading book with those in the banking book.

▪ ***Correlation trading portfolio:*** Correlation trading portfolio is defined to include securitisation positions and certain credit derivatives on single-name instruments, but exclude re-securitisation positions. An exception under CRD3 will permit banks to apply to their correlation trading portfolio the larger of either (i) the total specific risk capital charge applicable just to its net *long* positions or (ii) the total specific risk capital charge applicable just to its net *short* positions, where it would receive a 1,250% risk weight. The capital charge for all price risks of the positions in such portfolio are subject to a floor of 8%, i.e., it may not be less than 8% of the capital charge which would result under the standardised approach or IRB approach.

Technical amendments

CRD3 makes certain technical amendments to the text of CRD, including:

- ***Prudent valuation:*** CRD3 extends the application of the "prudent valuation" provisions of the Capital Adequacy Directive (2006/49/EC) ("**CAD**")[4] to all instruments which are measured at fair value, whether they are in the bank's trading or banking books. However, where that would lead to a lower carrying value than recognised in the accounting, the difference should be deducted from the bank's own funds. CEBS has been mandated to produce detailed guidelines.

- ***Settlement risk***: CRD3 amends Article 75 of the Banking Consolidation Directive (2006/48/EC) ("**BCD**") to clarify that the banks' capital requirements for "settlement risk" (as well as foreign exchange risk and commodities risk) apply to "all of their business activities", i.e., both their banking and trading books.

- ***Limits on potential future credit exposure ("PFCE"):*** A bank whose exposure to a credit default swap ("**CDS**") represents a *long* position in the underlying will be permitted to use a 0% PFCE, unless the CDS is subject to close-out upon insolvency of the underlying entity whose exposure represents a *short* position in the underlying. However, CRD3 limits the PFCE to the present value of the future premiums payable by the swap counterparty.

- ***Treatment of exposures to regional and local governments*****:** CRD3 clarifies that exposures to regional governments or local authorities of EU member states which are denominated and funded in their domestic currency will be assigned a risk weight of 20%, whilst being treated as exposures to institutions.

- ***External credit assessments:*** CRD3 introduces provisions which prevent banks from using a lower risk weight based on an external credit assessment for a securitisation position incorporating any credit protection provided by the bank itself. In such case, the relevant position will be treated as though it were unrated.

Next steps

Member states must implement the changes to the capital requirements under CRD3 by no later than 31 December 2011. The remuneration rules under CRD3 will become effective sooner, from 1 January 2011.

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[4]. Directive (2006/49/EC) on the capital adequacy of investment firms and credit institutions, http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en02010255.pdf.

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