EU Risk Retention Requirements Revised

On December 17, 2013 the European Banking Authority (EBA) issued its final draft of new rules relating to the retention by sponsors, originators and original lenders of credit risk (net economic interest) in securitization transactions.[1] This issuance follows a period of consultation based on a draft that was released in May 2013.[2] Although the new rules, which take the form of regulatory (RTS) and implementing technical standards (ITS), must still be approved (or not be objected to) by the European Commission, the European Parliament and the Council of the European Union before they can be published in the Official Journal (and thereupon become final 20 days after such publication), it may be useful to begin studying their structure and their possible implications. This is particularly true given that the RTS is worded in such a way that it would take effect of January 1, 2014 despite the delays caused by the approval process. The fact that the RTS and ITS in many respects follow the provisions of Articles 404 – 409 of the recently adopted Credit Requirements Regulations (CRR) of the European Union,[3] which they are intended to help implement, suggests that any changes made during the remaining part of the approval process may be minor, but they could nevertheless be significant. In addition, divining the manner in which already existing funds will be treated after December 31, 2013 requires a careful reading of what little the RTS says on this point.[4] Despite the material from the RTS quoted in footnote 4 below, there is a notable lack of clarity as to how the transition should be navigated.

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[1] EBA Final Draft Regulatory Technical Standards on the retention of net economic interest and other requirements related to exposures to transferred credit risk under Articles 405, 406, 408 and 409) of Regulation (EU) No 575/2013 and Final Draft Implementing Technical Standards relating to the convergence of supervisory practices with regard to the implementation of additional risk weights Article 407) of Regulation (EU) No 575/2013, available online at http://www.eba.europa.eu/documents/10180/529248/EBA-RTS-2013-12+and+EBA-ITS-2013-08+%28Securitisation+Retention+Rules%29.pdf. The spelling "securisation" and "overcollateralisation" will be retained in any direct quotations.

[2] Consultation Paper on Draft Regulatory Technical Standards on the retention of net economic interest and other requirements related to exposures to transferred credit risk under Articles 394, 395, 397 and 398) of Regulation (EU) No [xx/2013] and on Draft Implementing Technical Standards relating to the convergence of supervisory practices with regard to the implementation of additional risk weights Article 396) of Regulation (EU) No [xx/2013], available online at http://www.eba.europa.eu/documents/10180/209701/EBA-BS-2013-091rev2--RTS-ITS-securitisation-retention-rules-clean.pdf. The final draft of the RTS varies only in minor ways from the version released in May.

[3] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32013R0575:EN:NOT.

[4] The introductory material in the document containing the RTS notes the following about the previous regulations: "The RTS/ITS will replace the current guidance on Article 122a CRD II (CEBS guidelines and corresponding Q&A document). With the coming into force of the CRR on 1 January 2014, the guidance on Article 122a CRD II as implemented by competent authorities will remain relevant to competent authority's decision only when assessing: i) whether an additional risk weight should be applied in cases where there is a material breach of Articles 405, 406,

(continued...)

The RTS imposes risk retention requirements on credit institutions and investment firms acting as sponsors, originators and original lenders, each of which is referred to as a "retainer" when it is fulfilling the retention requirement. Only one of these three types of retainer may satisfy the requirements in any given case, although in some cases multiple retainers of the same type may share in satisfying them. The terms "sponsor" and "originator" are themselves defined in Article 4(1) of the CRR:

> (13) 'originator' means an entity which: (a) 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) purchases a third party's exposures for its own account and then securitises them;
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> (14) 'sponsor' means an institution other than an originator institution that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third-party entities;

On the other hand, the term "original lender" is defined, not in the RTS itself, but in the preamble to the RTS:

> The term original lender should be understood to refer to an entity which, either itself or through related entities, directly or indirectly, originally created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised and which is not the **originator** [*emphasis added*].[5]

The EBA's responses to comments received during the consultative process leading to the adoption of the RTS contain little in the way of an analysis of these three types of retainer except in the context of collateralized loan obligations (CLOs). According to the EBA, the inclusion of investment firms in the definition of "sponsor," along with credit institutions, means that asset managers may have retention obligations when managing CLOs. The EBA acknowledges that the capital of many asset managers is insufficient for these purposes and that, therefore, "[t]his could potentially translate in the long term into a modification of the currently existing managed CLO model."[6]

Despite this broadening of the definition of "sponsor," which was apparently intended to accommodate some of the comments of the CLO industry, only asset managers regulated under the Markets in Financial Instruments Directive will be eligible for such treatment, effectively precluding its availability to managers not regulated in the European Union or otherwise not subject to such regulation. Furthermore, the broadening has come along with the loss of the ability, available under the earlier Guidelines, for an asset manager subject to the risk retention requirements to satisfy them by utilizing the capital of an

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or 409 CRR by reason of the negligence or omission of an institution and where the respective securitisation position is part of a transaction issued on or after 1 January 2011 and before 1 January 2014, and, ii) how to interpret substitution of exposures for transactions before 1 January 2011 as referred in Article 404 CRR."

[5] Since this definition overlaps with the first part of the definition of "originator," it should perhaps be understood as referring to an originator that is not a purchaser.

[6] RTS, Draft cost-benefit analysis/impact statement, paragraph 25, p. 36.

affiliate.[7]

An essential, stated purpose of the RTS and the related, statutory provisions of the CRR is to align the interests of originators, sponsors and original lenders involved in a securitization with those of the investors holding tranches in the securitization. To accomplish this purpose, the RTS and the CRR require (i) investors in a tranche of a securitization to obtain the promise of the retainer that it will retain the required net economic interest,[8] (ii) originators, sponsors and original lenders to make material information readily available to investors;[9] (iii) sponsors and originators to apply the same standards to the risks they securitize as they apply to the risks they keep on their books;[10] (iv) investors and others becoming exposed to a securitization position to conduct due diligence;[11] and (v) retainers to hold their retained net economic interest in one of a limited number of ways.[12] The prohibition on hedging retained exposures also serves to retain an alignment of interests.[13]

The requirements imposed on the various parties are enforced in part by the imposition of higher risk weights on any securitization positions "affected by the ... infringement."[14] Which of the parties (i.e., the investor, the sponsor, the originator or the original lender) bears the extra capital burden caused by higher risk weights depends on which party caused the violation. Investors can be penalized for failing to obtain the required promise from the retainer or for failing to conduct the required level of due diligence, and sponsors, originators and original lenders can be penalized for failing to make proper disclosures to investors.[15] The extent to which the sponsor, originator or original lender retains a securitization position on which a higher risk weight can be imposed would appear to depend in part on the application of the

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7 The RTS also fails to deal specifically with the question of what happens when the portfolio manager of a CLO resigns.

8 RTS, Article 23.

9 RTS, Article 24(1).

10 RTS, Article 22; CRR, Article 408.

11 RTS, Articles 16 - 21.

12 RTS, Articles 4 – 12.

13 RTS, Article 13.

14 ITS, Article 1(1).

15 ITS, Article 1. Article 407 of the CRR provides as follows: "Where an institution does not meet the requirements in Article 405, 406 or 409 in any material respect by reason of the negligence or omission of the institution, the competent authorities shall impose a proportionate additional risk weight of no less than 250 % of the risk weight (capped at 1 250 %) which shall apply to the relevant securitisation positions in the manner specified in Article 245(6) or Article 337(3) respectively. The additional risk weight shall progressively increase with each subsequent infringement of the due diligence provisions." The reference to Article 405 incorporates the investor's responsibility to obtain a commitment from the retainer, the reference to Article 406 incorporates the investor's responsibility to perform adequate diligence, and the reference to Article 409 incorporates both the retainer's responsibility to disclose its commitment to retain and the responsibility of the sponsor and the originator to disclose the necessary information regarding the securitization.

relevant capital requirements to the particular case. Unless the original lender is the retainer, it may have no relevant securitization position at all.

Given that both investors and retainers can be penalized, the jurisdictional scope of the RTS and the CRR becomes important. Clearly if investors and retainers are both in the European Union (EU), the RTS and its penalties apply. The wording of the RTS also suggests that it will apply to investors if they are the only parties located in the EU and that it will apply to the retainers if only they are located there. Paragraph 13 of the preamble to the RTS states that entities that are themselves outside the EU but are consolidated with entities located in the EU

> should, in limited circumstances such as for exposures held in the trading book for the purpose of market-making activities, not be deemed to be in breach of Article 405[of the CRR, relating to the requirement that investors obtain a commitment from the retainer], where any such exposures or positions in the trading book are not material and do not 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 other words, in the general case, which may include the obligations of the retainer as well as those of the investor, the implication appears to be that they may be subject to the RTS.

The retainer is given a choice of seven different ways to retain a net economic interest, six of which are generally applicable and one of which relates only to asset-backed commercial paper (ABCP) programs. The manner of retention permitted for ABCP programs ((b) below) is treated by the RTS as a variant of (a), as is (c):

(a) Pro rata retention of at least 5% of the nominal value in each of the tranches sold or transferred to investors;
(b) The provision (as part of an ABCP program) by the originator, sponsor or original lender, for as long as the retention requirement lasts, of a liquidity facility covering 100% of the credit risk of the underlying exposures;[16]

[16] Interestingly, under Article 3(2) of the RTS the provider of certain liquidity facilities would have no exposure to the credit risk of a securitization exposure if the facility could be called at any time and satisfied the following additional conditions, which are found in Article 255(1) of the CRR: "(a) the liquidity facility documentation shall clearly identify and limit the circumstances under which the facility may be drawn; (b) it shall not be possible for the facility to be drawn so as to provide credit support by covering losses already incurred at the time of draw and in particular not so as to provide liquidity in respect of exposures in default at the time of draw or so as to acquire assets at more than fair value; (c) the facility shall not be used to provide permanent or regular funding for the securitisation; (d) repayment of draws on the facility shall not be subordinated to the claims of investors other than to claims arising in respect of interest rate or currency derivative contracts, fees or other such payments, nor be subject to waiver or deferral; (e) it shall not be possible for the facility to be drawn after all applicable credit enhancements from which the liquidity facility would benefit are exhausted; (f) the facility shall include a provision that results in an automatic reduction in the amount that can be drawn by the amount of exposures that are in default, where 'default' has the meaning given to it under Chapter 3, or where the pool of securitised exposures consists of rated instruments, that terminates the facility if the average quality of the pool falls below investment grade." It is unclear whether condition (c) means that it is intended that this provision not be available for facilities used in connection with ABCP programs.

(c) Retention, by means of a note, of a vertical slice creating pro rata exposure to the credit risk of the underlying exposures and with a nominal value of at least 5% of each issued tranche;
(d) Retention, in the case of revolving exposures, of a 5% pari passu or subordinated originator's interest in the underlying exposures;
(e) Retention of a randomly selected set of exposures from a pool containing at least 100 exposures;
(f) Retention by the originator, sponsor or original lender of a first loss tranche equal to 5% of the aggregate nominal value of all the underlying exposures; and
(g) Retention of a first loss position of at least 5% of the exposure's nominal value with respect to each underlying exposure.

Retention by an originator of a subordinated or pari passu interest of 5% or more satisfies method (a) above. The nature of such an interest is not defined in the RTS or the CRR. Perhaps it may consist in the sale of the interest at a discount of 5% or more, although the RTS expressly refers to that kind of retention only in connection with method (g).

The commercial paper issued by an ABCP program relying on method (b) above may not have a maturity in excess of one year. This is less than the maturity permitted by the newly released final version of the Volcker Rule (397 days, which was chosen to match the maximum maturity of instruments eligible to be held by US money market funds). The currently proposed US risk retention rules provide for a maximum maturity of only 9 months, but like the RTS they contemplate that the liquidity facility covers 100% of the credit risk. The potential variation created by these regulations in the maturities permissible for commercial paper issued by conduits may in some cases render planning more difficult and complicate compliance with terms of the future liquidity coverage ratio.

The retention method described in (f) as requiring a first loss tranche may also be satisfied by overcollateralizing the tranches of the securitization provided that "such overcollateralisation acts as a 'first loss' retention of no less than 5% of the nominal value of the tranches issued by the securitisation."[17] The provision of a liquidity facility of the form permitted for ABCP programs will also satisfy method (f).

The first loss position permitted by retention method (g) may be established by the originator's or original lender's selling its its exposures at a discount, "where this discount is not less than 5% of each exposure and is only refundable insofar as it is not absorbed by credit risk-related losses incurred on the securitised exposures."[18]

All of the retention methods may be satisfied by derivatives or other synthetic or contingent methods if they fully comply with the specific requirements associated with the chosen method and proper disclosure is made. Whether a derivative could replace or constitute a liquidity facility for purposes of method (b) (relating to ABCP programs) is unclear. The definition of "liquidity facility" in Article 2(1)(3) of the RTS seems sufficiently general, however:

> … a securitisation position arising from a contractual agreement to provide funding to ensure

[17] RTS, Article 9(1)(b).

[18] RTS, Article 10(2).

timeliness of cash flows to investors as defined in Article 242(3) of [the CRR].[19]

Unlike the proposed US risk-retention rule, the RTS and the CRR use nominal value, rather than fair value, as the basis for measuring compliance. At one point the RTS expressly states that the price paid is not the relevant value.[20] Both the US rule and the RTS agree that the time at which compliance is measured is the time of securitization, rather than the time of origination, but the RTS contains no detailed method for calculating the subsequent level of retention; rather, it just requires that the transaction not be structured so that the retainer's interest declines or is paid down more quickly than the interests of the investors.[21]

The rather protean nature of the risk retention and the jurisdictional provisions outlined above adds emphasis to the concern expressed in the initial paragraph that the delay caused by the remaining approval process requires careful analysis well before that approval process is complete.

For more information, please contact authors George M. Williams jr. and Stuart Axford, or lawyers in Kaye Scholer's Finance Department.

Chicago Office +1 312 583 2300	**Frankfurt Office** +49 69 25494 0	**London Office** +44 20 7105 0500
Los Angeles Office +1 310 788 1000	**New York Office** +1 212 836 8000	**Palo Alto Office** +1 650 319 4500
Shanghai Office +86 21 2208 3600	**Washington, DC Office** +1 202 682 3500	**West Palm Beach Office** +1 561 802 3230

[19] The referenced provision of the CRR adds nothing to the definition.

[20] RTS, Article 11(1)(b).

[21] "A retainer shall not be 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." RTS, Article 11(1)(e).