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Compliance Alert

EBA Finalizes Guidelines on Significant Credit Risk Transfer

On 7 July 2014, the European Banking Authority (EBA) issued its final "Guidelines on Significant Credit Risk Transfer relating to Articles 243 and 244 of Regulation 575/2013"[1] (Guidelines). The Guidelines will be part of the EU Single Rulebook in the banking sector and must be implemented by competent authorities (e.g., the FCA in the UK and BaFin in Germany) within six months of their adoption. The Guidelines' provisions applicable to competent authorities differ slightly from those applicable to originators, and this alert discusses the underlying substance of the provisions rather than their differences.

The Guidelines apply only to transactions that close after their adoption and are intended to assist competent authorities and credit institutions acting as originators[2] in determining whether significant credit risk has been transferred in a given securitization[3]. Without such a transfer, putatively securitized assets remain on the books of the originator. Furthermore, in the

1 The regulation as a whole (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) is typically referred to as the "CRR." The title of the Guidelines contains the word "Article" before "244." Given the use of the word "Articles" before "243," this would appear to be a typographical error.

2 An "originator" is defined in CRR Article 4(13) as "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; …" As so defined, the term appears to combine aspects of both a securitizer and an originator, as those terms are defined in Section 15G(a) of the US Securities Exchange Act of 1934: "(3) the term "securitizer" means—(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer; and (4) the term "originator" means a person who—(A) through the extension of credit or otherwise, creates a financial asset that collateralizes an asset-backed security; and (B) sells an asset directly or indirectly to a securitizer."

3 Except in quotations, where the original spelling (including the treatment of numbers and percentages) is retained, this alert follows American English orthographic conventions.

absence of a common understanding as to what constitutes such a transfer, institutions operating in various member states of the European Union may be subject to uneven regulation.

The Guidelines are intended as elaborations of the standards set forth in Articles 243(2), 243(4), 243(5), 244(2), 244(4) and 244(5) of the CRR. Articles 243(2) and 244(2) relate to risk transfer only and are only a small part of the other diligence and governance standards made applicable to securitizations by Articles 243(4), 243(5), 244(4) and 244(5). Article 243 deals with traditional securitizations, and Article 244 with synthetic ones. The remainder of this alert will focus on Article 243 and the related portions of the Guidelines. Although the provisions of the Guidelines applicable to competent authorities differ slightly from those applicable to originators, this alert will discuss what would appear to be the underlying substance of the provisions, rather than their differences.

Article 243(2) reads as follows:

> 2. Significant credit risk shall be considered to have been transferred in the following cases:
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> (a) the risk-weighted exposure amounts of the mezzanine securitisation positions held by the originator institution in this securitisation do not exceed 50 % of the risk-weighted exposure amounts of all mezzanine securitisation positions existing in this securitisation;
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> (b) where there are no mezzanine securitisation positions in a given securitisation and the originator can demonstrate that the exposure value of the securitisation positions that would be subject to deduction from Common Equity Tier 1 or a 1 250 % risk weight exceeds a reasoned estimate of the expected loss on the securitised exposures by a substantial margin, the originator institution does not hold more than 20 % of the exposure values of the securitisation positions that would be subject to deduction from Common Equity Tier 1 or a 1 250 % risk weight.
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> Where the possible reduction in risk-weighted exposure amounts, which the originator institution would achieve by this securitisation, is not justified by a commensurate transfer of credit risk to third parties, competent authorities may decide on a case-by-case basis that significant credit risk shall not be considered to have been transferred to third parties.

Article 243(4), on the other hand, contains more generic diligence and governance requirements applicable to securitizations and is described in the CRR as providing the basis for the grant by a competent authority to an originator of the right to make its own determination of significant risk transfer, independently of the requirements in Article 243(2). These requirements are, roughly,

- Appropriate risk-assessment policies; and
- Uniform application of the institution's transfer of credit risk.

Article 243(5), in turn, largely consists of specific limitations on the terms of securitizations:

- Documentation reflects economic substance;
- Securitization vehicle is bankruptcy remote, as evidenced by an opinion of counsel;
- Originator does not retain effective control over the transferred exposures, e.g., by virtue of repurchase rights;[4]
- Originator cannot improve the terms for investors after issuance;
- Yields do not increase upon a decrease in credit quality;
- Repurchases or positions must be exceptional and at arm's length; and
- Clean-up calls are limited in their scope.

Interestingly, the Guidelines provide little elaboration of the actual risk-transfer provisions in Article 243(2) or the specific requirements of Article 243(5). Most of the apparent references to Article 243(5) relate to the task of the competent authority in evaluating transaction structures. The Guidelines emphasize the implementation of systems and controls in their discussion of clauses (2) and (4) of Article 243. As to clause (4), which allows derogation from the requirements of clause (2), the Guidelines stress a consideration of:

- Capital and capital allocation policies;
- Comparative risk assessment of the various ways in which the assets could be treated;
- Capital benefits achieved as compared to the actual economic risk transferred;
- Costs incurred in the nature of premiums;
- Expected and unexpected losses in the pool of securitized assets;
- Structural issues and hedging;
- Pricing;

[4] Retention of servicing rights does not count as impermissible control.

- Counterparty credit risk;
- Links among the parties and assets;
- Tranche thickness;
- The detailed risk profile of the transferred assets and the suitability of any stress assumptions used;
- The robustness of any internal models employed, the presence of cliff or threshold effects in the models, and the overall level of risk management skill;
- Timing or hedging mismatches; and
- The competence of any rating agency whose ratings are used.

The absence of any detailed discussion of Article 243(2) is especially interesting because subclauses (a) and (b) of that Article together require that either: (i) a substantial mezzanine tranche must exist even if an originator retains only a five percent interest in assets it has transferred; or (ii)—if there is no mezzanine tranche, as opposed to one that is simply not substantial enough—a particular arithmetic relationship must exist between the retained amount and the amounts subject to a 1,250 percent risk weight or to deduction from the originator's common equity Tier 1. The notions of "substantial margin" and "expected loss" conceivably (depending on how the exposure formulas actually work in real transactions) could require some elaboration in this context, especially since the effect of Article 243(2) is to require the originator to transfer at least 80 percent of the least credit-worthy portion of certain exposures, something which may not be possible given the risk-retention requirements. Perhaps the EBA believes that the wording of Article 243(2) makes it unlikely to be used.

The analogous requirements applicable to US banks and bank holding companies for traditional securitizations are less elaborate:

- The relevant securitization exposures must not be reported on the institution's balance sheet;
- Credit risk must have been transferred to one or more third parties;
- If the underlying exposures permit a borrower to vary the amount drawn under a line of credit or contain an early amortization provision, the transferred exposures are treated as if they had not been transferred and any gain on sale must be deducted from Tier 1 common equity;

- Only "eligible" clean-up calls[5] are permitted; and
- The bank must demonstrate a thorough understanding of the manner in which the securitization operates and document its analysis of the underlying exposures, the structure of the securitization and market data relating to the securitization.[6]

Given the relative opacity of the US rules, especially the requirement that credit risk must have been transferred, much of the compliance burden in the US may be borne by those responsible for demonstrating their institution's thorough understanding of the transactions in which it engages and for carrying out the mathematical calculations required by the relevant formulas. It remains to be seen whether the EU or the US approach will best assist credit institutions and their regulators in reaching shared positions on risk transfer.

Contact Us

George M. Williams jr
+1 212 836 8840
george.williams@kayescholer.com

Stuart Axford
+44(0)20 7105 0523
stuart.axford@kayescholer.com

Hartmut T. Renz
+49 69 25494 230
hartmut.renz@kayescholer.com

Lawton M. Camp
+1 212 836 8281
lawton.camp@kayescholer.com

Karsten Giesecke
+1 212 836 8551
karsten.giesecke@kayescholer.com

Ingrid Kalisch
+49 69 25494 250
ingrid.kalisch@kayescholer.com

Sandra Pfister
+49 69 25494 240
sandra.pfister@kayescholer.com

[5] "*Eligible clean-up call* means a clean-up call that: (1) Is exercisable solely at the discretion of the originating [BANK] or servicer; (2) Is not structured to avoid allocating losses to securitization exposures held by investors or otherwise structured to provide credit enhancement to the securitization; and (3)(i) For a traditional securitization, is only exercisable when 10 percent or less of the principal amount of the underlying exposures or securitization exposures (determined as of the inception of the securitization) is outstanding; …" §__2 of the Common Rules adopted by all federal banking agencies. The Common Rules are found at 78 Fed.Reg. 62018 (Oct. 11, 2013).

[6] Section __.41(b) and (c) of the Common Rules.