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Client Alert

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Understanding the EU Retention Rule

"The new EU 5 percent retention requirement will affect many European securitisation transactions in unexpected ways."

On 31 December 2010, the Committee of European Banking Supervisors (CEBS) (now the European Banking Authority) published its final guidelines (the Guidelines) on the application of Article 122a of the Capital Requirements Directive (CRD). Article 122a of the CRD provides new requirements for banks acting as originators, sponsors and investors in securitisation transactions. The new requirements include retention on an on-going basis of a material net economic interest of not less than 5 percent (so called "skin in the game"), due diligence and disclosure. Both Article 122a and the Guidelines are to become effective in each EU member state from 1 January 2011.

This *Alert* summarises the main provisions of Article 122a and the Guidelines and answers some practical implementation questions for credit institutions that may be affected by the new rules. Article 122a will affect in unexpected ways an unusually broad range of European securitisation transactions. The new rules will change substantially the manner in which originators, sponsors and investors structure and execute such transactions.

Summary of Article 122A

Retention Requirement

In summary, a "credit institution", other than when acting as an originator, a sponsor or original lender, may acquire exposure to the credit risk of a securitisation position (whether in its trading book or its non-trading book) only if the originator, sponsor or original lender has explicitly disclosed to the credit institution that it will retain, on an ongoing basis, a "net economic interest" in the transaction.

For the purpose of Article 122a, the following terms have the following meanings:

- "Credit institution" means, essentially, a bank (*i.e.*, an undertaking that receives deposits and grants credit for its own account). It does not include investment firms, insurance or reinsurance companies or other financial institutions.
- "Originator" means an entity which, either itself or through related entities, directly or indirectly was involved in the original agreement that created the obligations of the debtor giving rise to the exposure being securitised, or an entity which purchases a third party's exposures onto its balance sheet and then securitises them.

- "Sponsor" means a credit institution other than an originator that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities.
- "Retention of net economic interest" (measured at origination) means:
  - Retention of no less than 5 percent of the nominal value of each of the tranches sold or transferred to the investors;
  - In the case of securitisations of revolving exposures, retention of the originator's interest of no less than 5 percent of the nominal value of the securitised exposures;
  - Retention of randomly selected exposures, equivalent to no less than 5 percent of the nominal amount of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is no less than 100 at origination; or
- Retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total no less than 5 percent of the nominal value of the securitised exposures.
- "Ongoing basis" means that retained positions, interests or exposures may not be hedged or sold.

The retention requirements are not applied more than once in any given securitisation transaction.

The retention requirement may be satisfied on the basis of holdings of a consolidated group if certain conditions are met. First, the parent credit institution or financial holding company must be located within the EU. Second, the parent credit institution or financial holding company, or one of its subsidiaries, as an originator or a sponsor, has securitised exposures from several credit institutions, investment firms or other financial institutions which are included in the scope of supervision on a consolidated basis. Third, the credit institutions, investment firms or financial institutions that created the securitised exposures have committed themselves to adhere to the disclosure and credit origination requirements summarised below.

Exemptions

The retention requirement does not apply where the securitised exposures are claims or contingent claims on or fully, unconditionally and irrevocably guaranteed by central governments or central banks; regional governments, local authorities and public sector entities of Member States; institutions to which a 50 percent risk weight or less is assigned under Articles 78 to 83 of the CRD; or multilateral development banks.

The retention requirement also does not apply to transactions based on a clear, transparent and accessible index, where the underlying reference entities are identical to those that make up an index of entities that is widely traded, or are other tradable securities other than securitisation positions, or to syndicated loans, purchased receivables or credit default swaps where these instruments are not used to package and/or hedge a securitisation.

Disclosure of Retention and Data

Originator and sponsor credit institutions must disclose to investors the level of their commitment to maintain a net economic interest in the securitisation. Originator and sponsor credit institutions shall ensure that prospective investors have readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation exposure as well as such information that is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures. For that purpose, materially relevant data shall be determined as at the date of the securitisation and (where appropriate due to the nature of the securitisation) thereafter.

Due Diligence and Monitoring

Credit institutions that acquire exposure to credit risk in a securitisation transaction must have a comprehensive and thorough understanding of, and have implemented appropriate formal policies and procedures for analysing and recording, among other matters, all of the relevant data disclosed to them, the essential characteristics of both the structure and the underlying exposures in the securitisation, applicable valuation methodologies, and the reputation and loss experience in earlier securitisations of the originator or the sponsor in the relevant exposure classes underlying the securitisation position. Such credit institutions must monitor and analyse all relevant performance data on an on-going basis.

In addition, credit institutions must regularly perform their own stress tests appropriate to their securitisation positions. They may use rating agency financial models to do so provided that they can demonstrate, when requested, that they took due care prior to investing to validate the relevant assumptions in and structuring of the models in order to understand methodology, assumptions and results.

Credit Origination Requirements

Originator and sponsor credit institutions must apply the same sound and well-defined criteria for credit-granting to exposures to be securitised as they apply to exposures to be held on their books. The same processes for approving and, where relevant, amending, renewing and re-financing credits must be applied. Credit institutions must also apply the same standards of analysis to participations or underwritings in securitisation issues purchased from third parties whether such participations or underwritings are to be held on the trading or non-trading book.

Where these credit origination requirements are not met, the originator credit institution may not exclude the securitised exposures from its balance sheet for purposes of determining its risk-weighted regulatory capital requirements under the CRD.

Regulatory Capital Penalties

Where the disclosure and due diligence requirements described above are not met in any material respect by reason of the negligence or omission of the investing credit institution, supervisors must impose a proportionate additional risk weight of no less than 250 percent of the risk weight (capped at 1,250 percent) more than the risk weight that would, but for this requirement, apply to the relevant securitisation positions under the CRD. The risk weight must progressively increase if the infringements continue.

Application

Article 122a applies to all new securitisations originated on or after 1 January 2011. It also applies to securitisations originated prior to 1 January 2011 if new underlying exposures are added or substituted in those transactions after 31 December 2014.

Implementation Issues and Advice

Applicability

As mentioned above, the retention requirement applies only to credit institutions that become exposed to the credit risk of a securitisation position. That Article 122a is limited to credit institutions (and not financial institutions more broadly) appears to be an error in the legislation itself, one that may be remedied going forward.

Types of Exposure

A credit institution can become exposed to the credit risk of a securitisation position in several ways, and Article 122a applies in each such case. First, the credit institution could acquire its exposure directly as an investor, whether in a cash or a synthetic securitisation. Second, the credit institution could be a liquidity provider to a securitisation. In that case, the Guidelines provide that Article 122a does not apply if the liquidity facility is an "eligible" liquidity facility (by being super-senior to all other securitisation exposures) or, if it is not "eligible", the liquidity provider does not assume the risk of principal losses in the transaction via the liquidity facility. Third, a credit institution could be a hedge counterparty to the transaction. In that case, the Guidelines provide that Article 122a does not apply if, pursuant to the hedge, the counterparty does not assume the risk of principal losses. In these second and third cases, the credit institution is exempt from Article 122a because it is not acquiring exposure to any credit risk. Finally, Article 122a will not apply if the transaction is not a securitisation.

Other exposures will need to be evaluated on their merits. For example, a bank providing a letter of credit to an ABCP conduit will likely be captured by Article 122a. Warehousing for a CLO may be captured if it is structured as a securitisation but would not be captured if it is structured differently.

Retaining Party

It is possible for parties in a securitisation to satisfy the 5 percent retention requirement even though those parties do not fit the roles of "originator" or "sponsor" according to the precise definitions of those terms summarised above. Two (non-exhaustive) examples include (i) the asset manager of a securitisation which is not a credit institution but which provides initial asset selection advice and/or ongoing management and substitution of exposures, and (ii) the most subordinated investor in a securitisation which provides structuring and asset selection advice (but is by definition neither the originator nor the sponsor, and nor is it the original lender). In such cases, if no other party is willing/able to take on the retention requirement, it may be necessary to structure the role of that party so that the definition of "originator" is met and the retention requirement can be fulfilled.

The primary consideration is that the party fulfilling the retention requirement must have an alignment of interest with the investors in the securitisation and that the transaction is not structured simply to re-distribute the technically "retained" exposure to third parties. Thus, for example, where a retained interest is placed with one or more of an asset manager's managed funds (which have no involvement in the relevant securitisation), alignment of interests is not achieved and such structures would not satisfy Article 122a.

Conversely, in a trade receivables securitisation the originator's retention of a subordinated deferred purchase price in respect of sold receivables that is at least equal to the required 5 percent threshold will likely satisfy the requirements of Article 122a.

Disclosure

Disclosure by an originator, sponsor or original lender of its retention should be made available publicly and should be appropriately documented. For example, a reference to the retention commitment in the relevant prospectus would be appropriate. Such disclosures may be made privately in a bi-lateral or private transaction, but the Guidelines provide that oral disclosures will not be considered adequate. The disclosure must be made at the time of origination and should be confirmed thereafter with the same frequency as the reporting frequency (but, at a minimum, annually) and at any point where the retention requirement is breached.

Hedging

The retention may not be subject to any credit risk mitigation, any short position or any other hedge. The transaction may not be structured so that the retained exposure is repaid faster than the other exposures (or even *pari passu* if retention is achieved by holding the most junior position). The aim is to disallow hedging that eliminates an originator's, sponsor's or original lender's exposure to the credit quality of the specific exposures that have been securitised. Within this objective, the Guidelines provide that originators, sponsors and original lenders have some flexibility to risk-manage their exposure to broader changes in the credit quality of the asset classes, collateral, or macroeconomic variables to which they are exposed via their lending activities, securitisation activities, or otherwise.

For example, in securitisations of trade receivables, originators sometimes purchase external credit insurance as part of their normal business operations. Similarly, mortgage guarantee insurance is sometimes taken out in respect of a pool of mortgage loans. Such types of insurance need not necessarily be considered to be "hedges" of the underlying exposures, if undertaken as a legitimate and prudent element of the credit process and if their usage does not undermine the required alignment of interest between the retained exposures and those sold to investors. For instance, mortgage guarantee insurance need not be considered a "hedge" when loans in the securitised pool of mortgages — and to which both the originator and investors are equally exposed — benefit from such insurance.

Multiple Application

Where a transaction involves a re-securitisation of one or more existing securitisations, this may result in retention occurring at more than one level (*i.e.*, in both the underlying securitisations and in the re-securitisation). However, this is an outcome of the re-securitisation process itself, and is not necessary to fulfil the requirements of Article 122a. Conversely, if the presence of two SPVs in a transaction is the result of the transaction's overall legal structure or the securitisation law of individual jurisdictions (*e.g.*, the need for a discrete borrower SPV and an issuer SPV, or financing via certain co-funding structures that require more than one SPV), this will neither require multiple application of retention under Article 122a, nor will it necessarily indirectly lead to multiple retention as an outcome.

Exemptions

The Guidelines suggest that the specific exemption for transactions "based on a clear, transparent and accessible index" or for "other tradable securities other than securitisation positions" are designed to apply to "correlation trading portfolios" (described under the Directive 2010/76/EU amendments to Directive 2006/49/EC (CRD 3)). For example, the Guidelines confirm that CDX and iTraxx are examples of "clear, transparent and accessible" indices to which the retention requirement of Article 122a would not apply.

Similarly, the exemption with respect to credit default swaps confirms that a credit default swap is not by definition automatically within the scope of Article 122a unless it constitutes a securitisation position. For instance, selling protection on a CDO via a credit default swap would be subject to the retention requirement, but selling protection on a corporate reference entity that does not constitute a securitisation would typically be exempt.

Additional Risk Weights for Infringements

The Guidelines establish formulas for imposing additional capital requirements on the basis of the position's original risk weight, the length of the infringement (in years), the 250 percent minimum increase and the 1,250 percent maximum. Capital requirements can increase substantially for positions with either high initial risk weights or lengthy infringement periods. Various tables and examples are provided in the Guidelines to illustrate the use of the formulas.

However, the additional risk weights do not apply to circumstances beyond the control of the credit institution, if such circumstances do not arise as a result of the negligence or omission of that credit institution. For example, if the retained exposure can no longer be maintained on an ongoing basis by the originator, sponsor or original lender (for instance, because its insolvency has led to asset disposals by the administrator of the now-insolvent originator, sponsor or original lender), or if the originator, sponsor or original lender having undertaken to fulfil the retention requirement subsequently inadvertently or intentionally breaches such undertaking (for instance, by disposing of the retained interest, contrary to its prior undertaking), this would not by itself trigger increased capital requirements for a credit institution. Moreover, a credit institution will not be obliged to dispose of such a securitisation position in these circumstances. However, a credit institution must factor these circumstances into any decision to invest in future securitisations involving the same originator, sponsor or original lender.

Substitutions of Exposures

The application of Article 122a to existing securitisations where new underlying exposures are added or substituted after 31 December 2014 does not have a threshold in terms of materiality or number of exposures. Further, the addition or substitution of new exposures does not include circumstances in which:

- The underlying obligor has not changed (*e.g.*, a mortgage loan borrower switching from one loan product to another, or a commercial real estate loan in which there has been a change of underlying rental agreement, lease, or tenant);
- Only the legal or ownership status of the obligor of an existing securitised exposure has changed (*e.g.*, an obligor entity has undergone a merger or change of legal form);
- There is substitution of one exposure with another exposure for very specific pre-defined contractual reasons pursuant to the original terms of such securitisation (*e.g.*, due to breach of the representations and warranties made upon sale of loans to such securitisation by the originator or original lender);
- There is repurchase of an exposure with cash due to reasons similar to those outlined above (*e.g.*, due to a breach of the representations and warranties made upon sale of loans to such securitisation);
- The maturity of an existing exposure is extended without such exposure being replaced by a new exposure; or
- There is a change in the size of an existing exposure due to increased utilisation of the available facility (*e.g.*, further advances under credit cards).

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