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Alternative Investments Practice Client Alert: EBA Risk Retention Report and Recommendations Released

The turn of every year since 2010[1] has seen new developments in European risk retention regulation and 2014 is no exception; year-end brought a double-helping of this annual bonanza, with new developments in both the United States and in Europe.

In the United States, the six federal agencies[2] published their joint final rule to implement the credit risk retention requirements of section 15G of the Securities Exchange Act of 1934 on 24 December 2014[3]. These U.S. risk retention rules will formally[4] take effect from 24 December 2015 for RMBS and from 24 December 2016 for other types of securitisation transactions.

In Europe, risk retention rules have applied since 1 January 2011. On 22 December 2014, as mandated by legislation[5] and at the further request of the European Commission, the European Banking Authority (the "**EBA**") published its report[6] and opinion[7] on the application and effectiveness of the European risk retention rules implemented by the EU Capital Requirements Regulation[8] and incorporating the EBA's recommendations for future reform. The EBA report is generally positive as to the application of necessary supervisory measures and degree of market compliance with the risk retention framework, albeit with some caution as regards whether national competent authorities have sufficient dedicated and prioritised resources to monitor compliance. With one notable exception (in its sixth recommendation, discussed below), the EBA report generally advocates maintaining the status quo. In light of this limited call for action, the potential desire for a new Parliament to move on from risk retention and take some of the more concrete measures necessary to bolster a stuttering European economy, as well as the admitted budgetary challenges facing Europe's regulators[9] and the multiplicity of other priorities juggling for their attention, there must also be some speculation as to whether the EBA report necessitates further legislative action; perhaps 2015 will be the year when the securitisation market finally takes a break from discussing new European risk retention initiatives.

In the remainder of this alert we briefly analyse the ten recommendations proposed in the EBA publications, with the four most significant proposals that are likely to be of particular relevance to the CLO industry being addressed first.

(A). EBA RECOMMENDATION 6: ORIGINATOR RISK RETENTION – CONCERNS ABOUT LOOPHOLES AND ABUSE

It will come as no surprise to those familiar with the various public and private pronouncements emanating from the EBA, or to those that have participated at the EBA's informal roundtable meetings, that the EBA report evinces some scepticism regarding originator retention. Any doubts about this sentiment and its strength are immediately dispelled by the pejorative vocabulary used in the EBA report with its reference to "loopholes" and "abuse". Specifically, and consistent with the concern identified and addressed by its predecessor, the Committee of European Banking Supervisors in the Guidelines[10] on Article 122a, the EBA is concerned that the breadth of the "originator" definition permits structures which interpose an originator special purpose vehicle (an "**Originator SPV**") in a securitisation. Where the Originator SPV involves third party equity investors, there then arises a risk of disassociating the alignment of interest between the party most appropriate to retain and the interests of investors, so side-stepping the "spirit" of the legislation.

Accordingly, the EBA report suggests that (a) the "originator" definition for risk retention purposes should be narrower so as to ensure a real alignment of interest between originator and investors, (b) originators should be of real substance, (c) originators should hold economic capital in assets for a minimum period of time, and (d) an originator's exposure to a securitisation should not be asymmetric[11]. The EBA recognises that these guidelines are somewhat opaque and that greater specificity may be necessary; and also, correctly in our view, recommends that an impact assessment should be conducted prior to implementing any change to the "originator" definition.

Despite the tone of the commentary and potential for resultant change in important and only recently enacted legislation, we believe there are several positives that the securitisation industry can take away from this section of the EBA report:

- at present, Originator SPV transactions can be (are) structured "so as to meet the legal requirements of the [Capital Requirements Regulation]". Although we must remember that the EBA is a policy-making, not a judicial body, and is not the final arbiter of the relevant decision, it is heartening to see this recognition that structurers need only comply with the law as stated and do not also have to divine and comply with the somewhat nebulous, undefined concept of the "spirit" of the legislation;

- it appears that the EBA's concern is focussed only on Originator SPVs that are funded by third party equity investors; Originator SPVs owned by a party with an alignment of interest – for instance, the ultimate parent of a collateral manager – are not singled out for criticism in the same way;

- many, if not all, of the Originator SPV structures seen in the securitisation market already impose a variety of economic substance requirements on the originator;

- many securitisation structures already provide that an originator must have held (or "seasoned") assets for a prescribed minimum period prior to onselling into the securitisation. However, these efforts have been hindered by the absence of any legal or accounting-based standard or policy recommendations defining what might constitute an appropriate seasoning period; and

- contrary to EBA concern, and at least so far as CLO transactions are concerned, any asymmetry in Originator SPV risk is usually structured to benefit investors. For instance, the CLO issuer will usually commit to acquire assets from an Originator SPV at the lower of cost or market value. Although initially counter-intuitive, this increases the prospect of a CLO successfully closing and the Originator SPV should ultimately recoup the value foregone through the enhanced performance of its retention investment.

(B). EBA RECOMMENDATION 1: PARTY RESPONSIBLE FOR COMPLIANCE – DIRECT OR INDIRECT APPROACH

In Europe, the risk retention regime primarily[12] operates "indirectly", and only allows regulated institutions to invest in securitisations when the requirements are satisfied. By contrast, the U.S. has taken a "direct approach" with the securitizer or sponsor responsible for compliance. The EBA report recognises the merits of both the direct and indirect approaches, and is particularly enamoured of the enhanced legal certainty[13] that the direct approach may bring for investors, resulting, potentially, in a larger securitisation market, as well as the prospects for legal enforcement.

Consequently, in addition to retaining the existing obligations imposed on European investors, the EBA report recommends (a) that the originator, original lender or sponsor (the "**Retainer**") of a securitisation should have a legal obligation to satisfy the retention requirement, and (b) prescribing disclosure in a standard form, which would include details of (i) the type of retainer (e.g. sponsor), (ii) the form of retention (e.g. vertical slice), (iii) the level of retention obligation (e.g. at least 5%), and (iv) whether the retention obligation will be satisfied solely by the Retainer or by the Retainer and other consolidated group entities[14].

Although sponsors and originators will not welcome the imposition and cost of these additional requirements, as a matter of market practice Retainers usually covenant to the securitisation issuer to comply with retention requirements; so the first recommendation would amount to expanding what is already a contractual obligation to one that is both contractual and regulatory. It also remains to be seen whether a legislature that has traditionally confined its jurisdiction to its 27 Member States will be inclined to the extra-territoriality involved in regulating and penalising originators and original lenders[15] with no European locus.

As a matter of best practice and, since the implementation of Article 22(1) of the relevant delegated regulation[16], legal requirement, disclosure documentation for CLO transactions routinely incorporates all of the information envisaged for the new standard form already; so the second recommendation would affect merely the form of current disclosure, rather than its content.

(C). EBA RECOMMENDATION 4: CONSOLIDATION – REGULATORY OR ACCOUNTING BASIS

In choosing the indirect approach to implementation, European regulators have focussed on the European banks and investment firms that invest in securitisations. From this perspective it is easy to understand the starting position in Article 405(2) of the Capital Requirements Regulation that retention positions should only be measured on a consolidated basis across entities that are regulated on a group basis. The EBA, in one of the shortest sections of its report, has recommended maintaining this approach and has not been tempted by an accounting consolidation approach, such as that favoured by the U.S. which permits retention via a "majority-owned affiliate". Although this approach avoids the potential dilution of economic ownership arising from (a) potential divestment of an affiliate, or (b) consolidation of an affiliate that is not a wholly-owned subsidiary of the ultimate parent entity, in our view these risks could be better addressed by the mechanics for measurement of the retained interest.

Paragraph 2.1.4(i) of the EBA report does note the challenges presented by the current "sponsor" definition in the Capital Requirements Regulation; however, the EBA is doing the securitisation industry and European economy no favours by not recognising that it is possible for an affiliate to satisfy the retention requirement whilst still maintaining the sponsor's alignment of interest. It is also rather curious that the recommendation is ostensibly predicated on the retaining entity needing to be within the scope of supervision on a consolidated basis; this supposition seems to overlook the fact (noted earlier in the report) that originators and original lenders may be located outside the EU and may be unregulated entities. We can hope that future publications from the EBA clarify its views and concerns in this area.

(D). EBA RECOMMENDATION 10: INTERNATIONAL DEVELOPMENTS AND CONVERGENCE

The longest section of EBA's report is devoted to its analysis of and findings on the regulatory approaches adopted in other jurisdictions internationally, most notably the U.S. as the world's deepest and most liquid capital market. This includes a detailed summary of the impending U.S. risk retention regime following publication of the proposed joint final rule in late October 2014, along with a comparison to the European requirements. A particular highlight of this section for CLO bankers, managers and investors everywhere is the well-expressed sentiment of the "critical importance of preserving securitisation as a global funding tool for real economy assets".

Rather more sobering is the understandable conclusion that although the thrust of EU and U.S. approaches to risk retention are similar, the overlap is marred by significant inconsistencies, and the observation that the need for transactions, particularly European securitisations, to comply with both regimes will materially increase compliance costs and may render some transactions uneconomic. The EBA is not alone in wishing for global convergence in an effort to support securitisation markets and enhance liquidity.

(E). EBA RECOMMENDATION 2: FORMS OF RETENTION

The EBA has assessed the choice and suitability of the five different methods of retention permitted under the Capital Requirements Regulation[17] and adjudged these appropriate and sufficient. After some consideration, the EBA dismissed the idea of expanding the permitted methods of retention to include an L-shaped form, primarily on the basis of (a) its increased complexity, and (b) due to a perceived reduction in the possible effectiveness of the alignment of interest that is intended to result from risk retention.

(F). EBA RECOMMENDATION 3: ALTERNATIVES TO RISK RETENTION

The EBA has concluded that the various possible alternatives to risk retention are merely complementary to, and not a sufficient substitute for, risk retention as a means of aligning the interests of investors and Retainers. In particular, this was notwithstanding the efforts of the CLO industry for recognition of the positive effects implicit in managers' performance-based fee arrangements. While approving of the natural incentive present in CLO fee structures, the EBA noted (a) that these structures are not a legal requirement, and (b) the asymmetrical nature of a fee-based mechanic (i.e. collateral managers are paid for good performance but are not required to make payment for poor performance).

(G). EBA RECOMMENDATION 5: EXEMPTIONS FROM RETENTION REQUIREMENT

As with possible alternatives to risk retention, the EBA report recommends no expansion of the existing exemptions and exceptions to the risk retention regime. The EBA has considered IOSCO's recommendation that an independently managed CLO (as opposed to a balance sheet CLO) might merit exemption from a risk retention requirement but, on balance, and noting the scope for structures that could take improper advantage of such an exemption, decided this is undesirable.

(H). EBA RECOMMENDATION 7: ADEQUACY OF DISCLOSURE REQUIREMENTS

Noting that disclosure is fundamental to investors' due diligence and risk analysis, the EBA concludes that the existing disclosure requirements under the risk retention regime are appropriate and fit for purpose and has recommended no change. As an aside, the EBA report also notes with approval that a task force has been convened under the aegis of the Joint Committee of the European Supervisory Authorities to identify and resolve any inconsistencies arising from the plethora of European regulations and initiatives affecting disclosure[18].

(I). EBA RECOMMENDATION 8: ADEQUACY OF DUE DILIGENCE REQUIREMENTS

The EBA report observes that although the due diligence requirements applicable to institutions investing in securitisations "significantly exceed what is required for comparable investment products", this is justified by the complexity of the securitisation product. Consequently, the EBA report concludes that the due diligence requirements applicable under Article 406 of the Capital Requirements Regulation[19] are sufficient and appropriate and recommends no change.

(J). EBA RECOMMENDATION 9: ADEQUACY OF SANCTIONS

With an apparent low level of non-compliance, the EBA's view is that the additional risk weights and administrative penalties that can be levied for violating risk retention requirements serve as an adequate deterrent and recommends no change.

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[1] The final CEBS Guidelines on Article 122a were published on 31 December 2010 in anticipation of the new Article 122a of CRD2, which was implemented by Directive 2009/111/EC taking effect from 1 January 2011.

[2] The Office of the Comptroller of the Currency of the Department of the Treasury, the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Securities and Exchange Commission and the Department of Housing and Urban Development.

[3] https://www.federalregister.gov/articles/2014/12/24/2014-29256/credit-risk-retention

[4] As a practical matter, many U.S. CLOs are already being structured in preparation for the effectiveness of the final rule. In particular, many such transactions are providing that any re-pricings, refinancings or tap issuances must be consented to by the collateral manager, in order to avoid such actions that may occur post 24 December 2016 triggering the need for a previously grandfathered CLO to comply with the risk retention requirements.

[5] Articles 410(1) and 512 of the Capital Requirements Regulation.

[6] https://www.eba.europa.eu/documents/10180/534414/Securitisation+Risk+Retention+Report.pdf

[7] https://www.eba.europa.eu/documents/10180/657547/EBA+OP+2014+14%28%20Securitisation+Risk+Retention+Opinion%29.pdf

[8] Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms. Specifically, Part Five, Exposures to Transferred Credit Risk, Articles 404-410. Similar requirements apply to alternative investment fund managers and other regulated investors.

[9] Per Andrea Enria, Chairman of the EBA and Steven Maijoor, Chairman of the European Securities and Markets Authority, 23 September 2014.

[10] https://www.eba.europa.eu/documents/10180/106202/Guidelines.pdf

[11] i.e. that an Originator SPV may benefit from upside, but not suffer downside from its acquisition of the exposures being securitised.

[12] See the observations below regarding Article 22(1) of the Delegated Regulation.

[13] There is some suggestion, however, in footnote 3 of the EBA report that any enhanced legal certainty would exist only with regard to compliance with the "spirit" of the retention requirement.

[14] Note that Article 405(2) of the Capital Requirements Regulation only permits shared retention by entities which "are included in the scope of [regulatory] supervision on a consolidated basis". i.e. Consolidation for accounting purposes is not sufficient.

[15] There is some suggestion in paragraph 2.1.1 of the EBA report that a "sponsor" may be located outside of the EU. This is implausible in light of the definition in Article 4(1)(14) of the Capital Requirements Regulation and the term is presumably used in the vernacular sense to refer to the instigator or progenitor of a securitisation.

[16] Commission Delegated Regulation (EU) No 625/2014 of 13 March 2014 (the "**Delegated Regulation**").

[17] Articles 5-9 of the Delegated Regulation also provide further clarification on the permitted methods of risk retention.

[18] e.g. CRD IV, the Prospectus Directive, the Transparency Directive, CRA3, AIFMD and Solvency II.

[19] As expanded by Article 16 of the Delegated Regulation.

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