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Client Briefing

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New EU securitisation risk retention rules – redrawing the roadmap

The new EU regulatory capital regime came into force on 1 January 2014 and with it a recasting of the securitisation risk retention rules. To accompany these new rules, the European Banking Authority (EBA) published final draft regulatory technical standards (RTS) in December 2013. The RTS and the accompanying implementing technical standards (ITS) are expected to be adopted in the first half of 2014 after consideration by the EU Commission and together will form an integral part of the final securitisation risk retention rules.

In this briefing we set out the key differences between the final draft RTS/ITS and the initial draft that was the subject of a consultation that closed in August 2013. Next we set out some of the key risk retention issues relevant to CMBS, CLO and portfolio acquisition transactions. We also include our views on some remaining areas of uncertainty relevant to market participants. Finally, we summarise the next phase of the evolving EU securitisation regulatory regime.

Background

The securitisation risk retention provisions of Article 122a of the Banking Consolidation Directive together with the related Committee of European Banking Supervisors (now the EBA) guidance and the Q&A published by the EBA (together, the 122a Guidance) no longer apply as of 1 January 2014. They are replaced by the Capital Requirements Regulation (CRR) which came into force on 1 January 2014 and will be complemented by the RTS/ITS when adopted by the Commission, provided no objection is made by the EU Parliament and Council of the European Union. The draft RTS and ITS were first released by the EBA in May 2013 as part of an industry consultation process. Set out below are the key differences between the new draft RTS/ITS and the drafts that were subject of the consultation.

Grandfathering for existing transactions –

The absence of grandfathering provisions in the consultation document was a significant concern that market participants raised during the consultation process. This is because, in the past, market participants relied heavily on the 122a Guidance as the authoritative interpretation of the text of Article 122a. During the consultation process it was therefore argued that investors who acquired securitisation positions relying in good faith on the 122a Guidance should not be penalised if the terms of the new RTS differ from the prevailing regulatory position at the time of initial issuance or acquisition of the investment.

Key issues

- Grandfathering still not permitted. Some clarifications regarding outstanding deals.
- Retention options for multiple originator deals clarified, potentially useful for managed CLOs.
- Further consideration of retention options for CMBS.
- Retention on a consolidated accounting basis not permitted.
- Synthetic retention by non-credit institutions will be difficult and expensive.

The EBA has indicated in its December 2013 publication that it will provide partial assistance. This assistance, however, will be useful only to current investors in transactions that were structured to comply with the old risk retention rules of Article 122a and the 122a Guidance and then only partially.

The assistance provided comes in the form of the EBA indicating that, when deciding whether to apply a punitive capital penalty to an investor holding an exposure issued between 1 January 2011 and 31 December 2013 that is non-compliant with the new rules, competent authorities may take into account compliance with Article 122a and the 122a Guidance. In that context, it seems unlikely that a punitive capital penalty will be applied to an investor so long as (i) the transaction was issued between 1 January 2011 and 31 December 2013; (ii) the transaction has continuously complied with Article 122a and the 122a Guidance; and (iii) the investor acquired the securitisation exposure prior to 1 January 2014. It seems unlikely to us that the EBA will extend this assistance to investors who acquire those same positions after 1 January 2014.

Even absent a punitive capital penalty for a current investor as at 1 January 2014, however, the possibility of such penalties being imposed on subsequent European investors will severely limit the secondary market liquidity of transactions that are compliant with Article 122a and the 122a Guidelines but not with the rules under the new regime. Consequently, the lack of grandfathering penalises existing investors as well as preventing new ones who are subject to the CRR from investing. If an investor is not subject to the CRR and is able to acquire instruments which are not compliant with the CRR, the purchase price they are willing to pay would need to take account of the more illiquid nature of the investment given that many potential investors would be subject to the CRR and unable to invest or, as may often be the case, unwilling to take the risk the instruments are not CRR compliant given the possible punitive capital penalty associated with holding the securitisation position. This is likely to adversely impact both the liquidity and market value of the instrument in the hands of the existing investors.

Fortunately, it appears that the number of transactions that were compliant with Article 122a and the 122a Guidance but not with the new regime is limited. Of those, the greatest concentration will be amongst CLO and CMBS transactions (both of which are further discussed below).

Grandfathering for pre-2011 securitisations –

In respect of transactions that were established before 1 January 2011, the risk retention rules will continue to be disapplied indefinitely where the underlying asset pools are left untouched. However, where new underlying exposures are added or substituted after 31 December 2014, that will cause the rules to apply to the transaction (but see below in respect of possible continuing relief until the 122a Guidance). That said, similar to transactions issued between 1 January 2011 and 31 December 2013, the background text and the Q&A section of the final draft RTS/ITS state that the 122a Guidance and Article 122a may be used to interpret the rules relating to substitutions of exposures, including product switches, warranty breaches, balance increases and reinvestments.

Unfortunately, reference to the interpretation of substitutions for pre-2011 transactions is not included in the main body of the RTS or ITS. Article 1(7) of the ITS only applies to the risk retention and disclosure rules of Article 405, 406 and 409 of the CRR, and does not apply to Article 404 of the CRR which sets out which transactions are within the scope of the risk retention rules. As the background text and Q&A will fall away when the RTS/ITS is adopted, it appears that the final RTS/ITS themselves will not provide clarity on how substitutions for such transactions should be interpreted. This may be due to the fact that the mandate of the EBA (pursuant to Article 410(2) of the CRR) did not extend to providing guidance on the application of Article 404 of the CRR.

Notwithstanding this, we believe it is helpful that the EBA has indicated that for securitisations issued prior to 1 January 2011, the 122a Guidance will be relevant when formulating regulatory views in respect of substitutions of exposures. Under the 122a Guidance, where there is a substitution of exposures for very specific pre-defined contractual reasons pursuant to the original terms of a pre-2011 securitisation, such securitisation will not become subject to the risk retention rules but will remain outside their ambit.

Non-EU trading books –

The consultation document did not provide any flexibility for EU banking groups undertaking market-making activities of securitisation positions through subsidiaries or branches in non-EU jurisdictions. Significant concern was raised during the consultation process that this may operate as a restriction on the ability of EU banking groups to undertake market making activities in non-EU jurisdictions (in particular, the US).

The final draft RTS goes a long way to clarify this, providing that institutions shall not be deemed to be in breach of the CRR risk retention rules where the securitisation positions are held in the trading book for the purposes of market making activities (among other conditions). Provided these conditions are met, subsidiaries or branches of EU banking groups acting as market makers in non-EU jurisdictions should not be caught by the retention rules.

Multiple originators/original lenders/sponsors –

The new draft RTS also provides some additional clarity in cases where more than one originator/original lender/sponsor is involved in a transaction.

In general, where more than one originator or original lender created the assets being securitised, retention must be satisfied by each on a *pro rata* basis. However, the EBA has added a new provision which allows retention to be fulfilled by a single originator or original lender if (i) the originator or original lender has established and is managing the securitisation or (ii) the originator or original lender has established the securitisation and has contributed over 50% of the total assets.

In the case of sponsors, the retention may be fulfilled either by the sponsor whose economic interest is most appropriately aligned with investors or by each sponsor on a *pro rata* basis.

New vertical slice notes –

To date, there has been a more limited use outside of CLOs and some CMBS of retention option (a), the vertical slice. There are likely to have been a number of reasons for this, including the ease of retaining the first loss (option (d)) and practical worries around retaining pieces of multiple tranches. The EBA has introduced guidance confirming that option (a) may be achieved by retaining a vertically tranched note which has a nominal value of no less than 5% of the total nominal value of all issued tranches of notes.

This does not seem to add significant flexibility to what was already contained in the primary text of the CRR. Therefore, it remains to be seen if this option will be economically attractive to retainers and acceptable to investors.

Liquidity facilities –

The consultation document provided that *only* liquidity facilities which fit within certain narrow criteria set out in what is now Article 255(2) of the CRR would be exempt from the risk retention requirements. These criteria include the unconditional ability of the facility provider to cancel the facility, limitations on the purpose for which the facility may be used (including a prohibition on using it to provide credit support in respect of defaulted assets or losses already incurred at the time of the draw) and a requirement that repayment of the facility must rank senior to payments of principal or interest on the notes.

The industry was concerned that many liquidity facilities for existing and new transactions would not fit within this definition and would therefore be subject to the risk retention rules in the same way as it applies to noteholder investors.

The new draft RTS clarifies that any liquidity facility provider which assumes the credit risk of the securitised exposures or the securitisation positions will be deemed to become exposed to the credit risk of a securitisation, and thereby subject to the CRR risk retention rules. This general test is also applied to derivative and hedge counterparties.

While it will depend on the facts of each particular transaction, to the extent that a liquidity facility provider, or derivative or hedge counterparty, is a senior creditor in the securitisation waterfall and does not become exposed to the credit risk of the assets, it should not be subject to the risk retention rules. In practice this is likely to turn on whether the borrowing base for a liquidity facility (or notional for a derivative) includes defaulted assets.

Retention on a synthetic or contingent basis –

The EBA has introduced a new restriction regarding retention on a synthetic or contingent basis. Examples of synthetic or contingent retention may include retention by way of a total return swap on the most subordinated tranche of the securitisation or a letter of credit to the securitisation.

The new draft RTS provides that where an entity other than a credit institution acts as a retainer on a synthetic or contingent basis, the interest retained must be fully cash collateralised and held on a segregated basis as clients funds. This additional requirement will limit the ability of non-bank entities (including investment firms) to act as the retainer using this method.

Retention on a consolidated basis –

Article 405(2) of the CRR provides a limited ability to retain on a consolidated basis, which has been used in the past as a means of retaining within a group by an entity which may not strictly qualify as an originator, original lender or sponsor. However, this flexibility is heavily restricted as in order to retain on a consolidated basis, there must be an EU parent institution (credit institution, financial holding company or mixed financial holding company), the transaction must securitise assets from several sellers, and such sellers must be included in the same group for regulatory supervision purposes (rather than for accounting purposes).

The final draft RTS does not provide any further flexibility to permit retention on a consolidated basis. The EBA have expressed a view in public meetings and in the Q&A of the RTS that they are limited by the primary text of the CRR in this regard.

CMBS

Article 405 of the CRR includes a new retention method that was previously not available under Article 122a of the CRD. Article 405(1)(e) now provides that retention may be achieved by the holding of a first loss exposure of not less than 5% of every securitised exposure in the securitisation.

The new draft RTS also includes clarification that this option may be applied so that the credit risk retained is always subordinated to the credit risk securitised. Initial industry reaction was that new option (e) could be helpful for CMBS transactions. For some CMBS transactions, this may be the case.

Where a commercial real estate loan is structured as a whole loan it is now possible that the junior part of the loan (the B loan) can be retained as a valid retention under option (e).

However, care must be taken to understand what constitutes the securitised exposure and in this context it may be helpful to distinguish between whole loans which are tranched at the time of the securitisation (or shortly beforehand as part of the contemplated securitisation) and whole loans which are tranched at origination (for instance, to facilitate the earlier syndication of the B loan) but where securitisation of the A loan occurs only at a later date.

In the first case, it is clear that retention of the newly created B loan would satisfy the retention requirement under new option (e). The B loan can be retained by the originator or original lender, and the A loan will be securitised through the issue of various tranches of notes.

While structuring such loans, if the original lender is not proposing to hold the B loan, care will have to be taken to ensure that the lender intending to hold or acquire the B loan has an adequate involvement in the origination process so that it can qualify as an Originator under the CRR. For example, it may be a party to the original agreement to provide an undertaking to acquire the B loan at the time of securitisation, and be involved in the loan origination process (including structuring, diligence, documentation and conditions precedent). However, it should be noted that the level of involvement of a B lender required to qualify as an Originator (under the CRR) may require the B lender to have regulatory approval in certain jurisdictions (in particular, in jurisdictions which have a banking monopoly). This may be particularly relevant for non-bank B lenders.

Multi-loan CMBS may also be able to implement retention option (e). In such a case, each B lender by holding its respective B loan will retain its *pro rata* share, thereby satisfying the requirements of Article 4(2) of the RTS.

In the case of whole loans that are tranched into A and B pieces but are not immediately securitised, the position remains unclear. There is a concern that the original A/B whole loan could constitute a securitisation (with the A loan and B loan both being tranched), meaning that the subsequent tranching of the A loan (into notes) could be considered a re-securitisation. This would attract punitive capital treatment for the noteholders. Industry will likely need to request further guidance on such transactions, perhaps in the form of a question and answer through the Q&A facility on the EBA website. In any case, regulators have not historically been willing to accept a unilateral change in the characterisation and hence capital treatment of a given position over time. It therefore seems unlikely that an institution would be able to tranche a loan into A and B pieces and treat them as non-securitisation exposures but then subsequently tranche the A loan into notes (and hold the B loan as the retention piece) while simultaneously arguing that the A/B loan should now be treated as a securitisation.

It should also be noted that option (e) will be of limited use with respect to structurally subordinated B or mezzanine loans (usually structured as a debt at the holdco level). Loans that are structurally subordinated are not part of the exposure that is being securitised (i.e., it is not a whole loan). Hence, it would not qualify as a securitised exposure for the purposes of option (e).

CLOs

When the initial draft of the RTS was published in May 2013 there was consternation in the CLO industry due to the fact that it did not countenance the retention piece being held by an independent third party investor whose interests were most aligned with those of other investors in the transaction as contemplated in the 122a Guidance. Unsurprisingly the final RTS/ITS published in December 2013 has not reintroduced this flexibility. However, certain clarifications relevant to managed CLOs have been included in the final draft RTS/ITS (in some cases, the following restates more specifically points made generically elsewhere in this briefing):

(i) where there are multiple originators of the exposures (as would typically be the case in a managed CLO transaction where assets are acquired in the market both during the warehouse and ramp-up phases as opposed to from the balance sheet of one particular seller), an entity may act as retention holder if it either (a) created or sold some of the assets into the CLO (there is no minimum percentage requirement) and has established and is managing the CLO, or (b) created or sold over 50% of the assets into the CLO and established the CLO but without needing to have any ongoing management role. The EBA have not confirmed whether a first loss warehouse provider can act as retention holder but a question has been submitted in relation to this on the EBA website which is currently awaiting answer;

(ii) if a CLO which issued prior to 1 January 2011 permits asset substitutions after 2014, for example because its reinvestment period is still continuing after this point in time, or otherwise because limited substitutions are permitted post-reinvestment period, the EBA have indicated that such transactions will be subject to the 122a Guidance when it is determined if they are subject to the CRR risk retention rules. This should mean that if asset substitutions are only permitted post-2014 for very specific pre-defined contractual reasons pursuant to the original terms of the CLO, that such CLO should fall outside the ambit of the risk retention rules;

(iii) for CLOs which issued in the period from 1 January 2011 – 31 December 2013 and which were structured so that the retention holder was an independent third party equity investor, regulators may take into account the 122a Guidance when determining if investors failed to comply with the CRR in entering into any such investments. This implies that regulators will show some leniency to investors in such CLOs who acquired their position in good faith on the basis of the then current 122a Guidance and therefore not be subject to a punitive risk weighting on their investment. However, such investors are still likely to suffer a loss of liquidity and possibly market value on such investment;

(iv) unfortunately no provision has been made for the retention piece to be held on a consolidated accounting basis and the restrictive and difficult drafting of the CRR must be complied with in respect of any consolidated holding; and

(v) no accommodation has been made for an entity to act as retention holder which does not fit within the technical definition of sponsor, for example due to it not having certain specified MiFID permissions.

Portfolio Acquisitions

As part of the general deleveraging of EU banks' balance sheets, many EU banks have sold and are continuing to offer for sale portfolios of loan exposures to hedge funds, private equity and other types of investment vehicles. Often on the buy side these transactions are structured by establishing orphan special purpose vehicles to buy the portfolio from the selling bank, with the SPV financing such acquisition through a combination of equity and limited recourse debt from the bank market.

To date, the market has not acted consistently in determining if these transactions fall within the securitisation risk retention rules. Unsurprisingly, the new RTS does not provide any clarity. However, in most cases it should be possible to determine whether such a transaction falls within the securitisation definition on the facts without the need for further guidance.

Where the external debt for the acquisition is funded by a single loan or single class of notes, this should not constitute a securitisation even if the equity is provided in debt form by way of profit participating notes. In our view, this does not amount to tranching of credit exposure. In this respect, regulators have in the past indicated that they will look to the substance of the investment to determine if the bottom tranche has the characteristics of true equity (bottom ranking, no guaranteed returns, right to participate on dissolution, etc.) and determine accordingly whether there is a securitisation.

However, where the external debt for the acquisition is funded by way of debt, such as a senior loan/note and a mezzanine loan/note, the analysis is more complex and it may be difficult on the face of the drafting of the regulations to fall outside the risk retention requirements. Structurally subordinating the mezzanine loan/note by providing funding through a holdco as a senior borrower (rather than being subordinated contractually) may not of itself be sufficient to address the concern.

Next steps

The final draft RTS has been submitted by the EBA to the Commission on 17 December 2013. From receipt of the draft, the Commission has three months in which to decide whether to adopt the RTS in full, in part or with amendments, or indeed not to adopt them at all (a result that seems highly unlikely). Following adoption of the RTS by the Commission, the European Parliament and the Council of the European Union will have a period in which they are entitled to object to the adoption of the RTS. That objection period lasts three months (extendable for a further three months by either the Parliament or the Council) or, if the Commission adopts the EBA's draft "as is", it will last one month (extendable for a further month by either the Parliament or the Council). Only once these objection periods have finished or both the Parliament and the Council have confirmed they do not intend to object can the RTS be published in the Official Journal. Legislation typically comes into force 20 days following publication in the Official Journal.

In this context, it may well be that there is no RTS in force before April 2014, and it is entirely possible that it could be significantly later than that. This is despite the fact that the CRR rules replaced Article 122a from 1 January 2014 and that the 122a Guidance no longer applies. In the interim, there will be a level of uncertainty surrounding aspects of the risk retention rules in securitisations that do not squarely fit within the provisions of the CRR. We expect that industry will need to spend time assimilating the new rules, commenting on them (possibly including attempting to address some of the outstanding issues raised in the EBA consultation via discussions with the Commission) and submitting questions to the EBA to take advantage of the Q&A facility that will eventually be published on the EBA website. As a result of this uncertainty, new securitisations in the first part of 2014 are more likely to be concentrated around more straightforward transactions that are clearly within the provisions of the CRR itself. Conversely, it may be that some securitisations with more complex or unusual retention structures are held back until later in 2014 when the detailed rules are finalised through the RTS and ideally, further assistance is given by the EBA through specific Q&A.

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