Clients&FriendsMemo

THE EBA REPORT ON SECURITISATION RISK RETENTION, DUE DILIGENCE AND DISCLOSURE – MORE OF THE SAME FOR THE CLO MARKET?

8 January 2015

INTRODUCTION

On 22 December 2014, the European Banking Authority (the "EBA") published an opinion[1] and a report[2] (together, the "Report") on securitisation retention, due diligence and disclosure requirements under Regulation (EU) No 575/2013 (the "Capital Requirements Regulation"). The Report contains advice from the EBA that takes the form of:

- Nine recommendations on the overall appropriateness of the securitisation retention, due diligence and disclosure requirements under the Capital Requirements Regulation; and
- One recommendation on the convergence of the risk retention regulatory frameworks.

The Report responds to the European Commission's call for advice dated December 2013 relating to Article 512 of the Capital Requirements Regulation which requires the European Commission to report to the European Parliament and the Council by 31 December 2014 on the application and effectiveness of the securitisation retention, due diligence and disclosure requirements in light of international market developments. The Report has also been developed in accordance with Article 410(1) of the Capital Requirements Regulation which requires the EBA to report annually to the European Commission on the measures taken and compliance by competent authorities with Articles 405 through 409 of the Capital Requirements Regulation.[3]

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

2 http://www.eba.europa.eu/documents/10180/534414/Securitisation+Risk+Retention+Report.pdf

3 The EBA has reviewed the supervisory measures taken by competent authorities to ensure compliance with securitisation retention, disclosure and due diligence requirements. This assessment shows that action has been taken in most jurisdictions to enforce the Capital Requirements Regulation securitisation framework. However, the section of the Report setting out this assessment is not the subject of this memorandum.

Although most of the recommendations of the EBA contained in the Report are recommendations that "no change" be made to the current European regime for securitisation retention, due diligence and disclosure, there are a number of recommendations which, if implemented by European legislators, will be significant to the European CLO market. These recommendations are:

- keeping the indirect approach for risk retention and implementing a complementary direct approach - *see* recommendation 1 considered in "Rules to apply to originators too?" below;
- narrowing the "originator" definition and defining it in further detail to reduce the potential misuse of the retention requirements "via legal definition loopholes" - *see* recommendation 6 considered in "Originator structures" below; and
- developing more alignment and consistency between risk retention regulatory frameworks and encouraging convergence between regimes - see recommendation 10 considered in "Convergence of the risk retention regulatory frameworks" below.

RULES TO APPLY TO ORIGINATORS TOO?

The Report draws a distinction between the approach adopted by the Capital Requirements Regulation of imposing risk retention rules on investors (which the Report calls the "indirect" approach) and the approach adopted in other jurisdictions, including the United States, of imposing risk retention rules on the originator of a securitisation (which the Report calls the "direct" approach). The EBA discusses the merits of each approach, including that:

- the "indirect" approach causes legal uncertainty for investors because it is difficult to ascertain whether the original lender, originator or sponsor is complying with the risk retention rules on an ongoing basis; and
- a "direct" approach would:
  - reduce this legal uncertainty of non-compliance (and associated compliance costs) which has the potential to encourage new investors to invest in securitisations;
  - provide for cross-border consistency; and
  - raise enforceability issues in respect of originators, original lenders and sponsors not covered by the rules or based outside the European Union.

Having discussed these issues, the EBA concludes[4] by recommending that the current "indirect" approach be retained and a "complimentary direct approach" be implemented. The Report goes into no detail by what is meant by "complimentary", although it seems to recommend that, in addition to the current regime of requiring investors to ensure that the risk retention rules are satisfied, there should be a requirement on originators to ensure compliance.

[4] *See* recommendation 1.

ORIGINATOR STRUCTURES

Article 405 of the Capital Requirements Regulation requires one of the "originator", "sponsor" or "original lender" to retain the material net economic interest. "Originator" is defined[5] to include "an entity that purchases a third party's exposures for its own account and then securitises them". Accordingly, CLO transactions have been structured on the basis that an entity acquires loans in the secondary market, holds those loans for a period of time and subsequently sells those loans to the CLO vehicle. Such an entity would technically fall within the definition of "originator" and would be eligible to retain the material net economic interest for the purposes of Article 405. In structuring such transactions, concerns have been raised over a number of issues including:

- what is required for an originator to have been said to have purchased a third party's exposure "for its own account"; and
- the economic substance the "originator" entity is required to have[6]

In the Report, the EBA notes that some transactions have been structured so as to meet the legal requirements of the Capital Requirements Regulation but actually do not always meet the "spirit" of the regulation. In particular, the EBA considers that the following structures would not meet the "spirit" of the regulation:

- an "originator SSPE" funded by third-party equity investors that meets the legal definition by acquiring a third party's exposures and securitising these exposures within one day;
- an "originator SSPE" that has asymmetric exposure to a securitisation and benefits from any "upside" but not "downside" of the retained interest.

The EBA concludes[7] by recommending that the definition of "originator" in the Capital Requirements Regulation be reassessed and narrowed further to ensure that industry participants do not abuse the rules and to ensure that the entity claiming to be the "originator" is of real substance and holds actual economic capital on its assets for a minimum period of time.

The EBA gives no guidance as to what may be required for there to be "real substance" to the originator, what the minimum period of time the originator would need to hold third-party exposures may be or the type of risk (for example, credit and/or market) that the originator would need to take in respect of such exposures. However, the EBA is clearly focussed on, and therefore any structure should carefully consider, the "spirit" of the regulations.

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5 Article 4(1)(13) of the Capital Requirements Regulation.

6 For example, where an originator has been established as an SPV so as to technically fall within the definition of "originator", but that SPV in turn has its retained credit risk assumed by an entity that neither meets the definition of originator or sponsor nor fulfils the role of original lender, investors are concerned that there is a risk that regulators will ignore the SPV and instead look to the entity which ultimately retains the credit risk.

7 *See* recommendation 6.

References in the Report to the need to consider the ownership and funding of the originator on the one hand, and the extent to which the originator is engaged in other loan origination business as well as the intended holding period for loans to be sold by the originator into securitisations on the other, suggest there may be a trade-off under which, for example, originators that are fully owned and funded by the CLO collateral manager (as opposed to third-party investors) would not need to retain assets for as long a period of time before securitising them (or demonstrate the existence of a wider loan origination business to the same extent) as originators that are funded by third-party investors.

The EBA notes that should the European Commission wish, they will do further work on the definition of "originator". There is no timeframe for such additional work to be undertaken however the EBA has recommended that an impact assessment be undertaken prior to any changes. This is welcome news as there will hopefully be ample opportunity for the CLO market to engage with the EBA and national regulators prior to any changes.[8]

CONVERGENCE OF THE RISK RETENTION REGULATORY FRAMEWORKS

The Report considers other international developments relating to risk retention, disclosure and transparency and describes some of the proposals and rules in Australia and the United States.

The EBA notes that although the thrust of regulation being implemented in other jurisdictions is similar, there are several differences in the general approach, retention methods and scope of application resulting in significant inconsistencies between the frameworks and that this lack of consistency will most likely affect the EU securitisation market by requiring issuers to comply with requirements in multiple jurisdictions if they wish to arrange deals on a cross-border basis, increasing compliance costs which may mean transactions are not economically feasible.

The EBA concludes[9] that to ensure a global level playing field and to support the cross-border securitisation market and the liquidity for the product, the risk retention rules should be implemented globally in a consistent way. Although the stated objective of this recommendation is to be commended, no guidance is given as to how it may be achieved.

OTHER ISSUES RAISED BY THE REPORT

As noted above, most of the recommendations of the EBA contained in the Report are recommendations that "no change" be made to the current European regime for securitisation retention, due diligence and disclosure requirements.

The issues raised in relation to which the EBA concludes that "no change" be made are:

- the possibility of including an "L-shape" form of retention in addition to the five methods of retention currently permitted under Article 405.

[8] Cadwalader, through its work with the Loan Markets Association, will continue to engage with the EBA and national regulators on these issues.

[9] See recommendation 10.

The EBA concludes[10] that an L-shaped form of retention would not be as effective in aligning interests and mitigating risks for investors and may add complexity to measuring the net economic interest.

- the possibility of alternative mechanisms to achieve alignment of interests.

  The EBA notes that mechanisms other than risk retention rules may be used to achieve the alignment of interests desired by regulators. These mechanisms could include "natural" incentives including the development of client relationships, focusing remuneration on long-term sustainable profitability and the desire to protect reputation and ongoing funding needs; and more "formal" mechanisms including requirements with respect to asset underwriting standards, transaction underwriting standards, buy-side due diligence requirements, disclosure requirements and performance-based fee arrangements for CLO managers.

  The EBA concludes[11] that it does not consider that any of these alternative mechanisms should be used as a substitute for the current risk retention rules.

- the possibility of considering compliance with the risk retention rules by looking at the position of the retainer on an "accounting" consolidated basis.

  Article 405(2) of the Capital Requirements Regulation provides that where an EU parent credit institution, an EU financial holding company, an EU mixed financial holding company or one of its subsidiaries, as an originator or a sponsor, securitises exposures from several credit institutions, investment firms or other financial institutions which are included in the scope of supervision on a consolidated basis, the retention rules may be satisfied on the basis of the consolidated situation of the related EU parent credit institution, EU financial holding company, or EU mixed financial holding company. Although it has been clear since implementation of Commission Delegated Regulation (EU) No 625/2014 (the "RTS") that consideration of the retention rules on a consolidated basis is only permitted in the circumstances provided for in Article 405(2) (that is, looking at consolidation on a regulatory supervisory basis),[12] the EBA appears to have considered again the issue of whether this should extend to looking at consolidation on an accounting basis.

  The EBA concludes[13] that the scope of consolidation should not be expanded to include accounting consolidation based largely on the concern that competent authorities may not

[10] *See* recommendation 2.

[11] *See* recommendation 3.

[12] Although now largely superseded by the RTS, the guidance issued in respect of Article 122a (the predecessor of Articles 404-410) recognised that the ability to fulfil the requirements of Article 122a on a consolidated basis should also apply to originators or original lenders other than credit institutions. That is, entities that may be consolidated for accounting purposes but not for supervisory purposes.

[13] *See* recommendation 4.

have jurisdiction over entities consolidated with the retaining entity on an accounting basis and not a regulatory supervisory basis, thereby making enforcement difficult.[14]

- the possibility of additional exemptions to the risk retention rules.

  The EBA notes the limited number of exemptions in Articles 405(3)[15] and 405(4)[16] from the risk retention rules. Although the EBA notes the economic differences between managed CLOs and the difficulties with CLO managers satisfying the retention rules, the EBA concludes[17] by recommending that no further exemptions to the retention rules should apply. However, the EBA does recommend further assessing the possibility of introducing an "exceptional circumstances" provision whereby under certain circumstances the retainer could be changed during the life of the securitisation transaction to ensure that the retainer is always the most appropriate entity to whom the interests of the investors should be aligned. It is hoped that this recommendation will result in the consideration of the position where a CLO manager holding as a sponsor has its appointment terminated or becomes insolvent.

- the disclosure requirements.

  Article 409 of the Capital Requirements Regulation provides that sponsor and originator 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". Article 23 of the RTS provides that in order for data to be considered to be materially relevant with regard to the individual underlying exposures, it shall, in general, be provided on a loan-by-loan basis, however there are instances where the data may be provided on an aggregate basis.

  The EBA considers whether the disclosure requirements should be more prescriptive by prescribing reporting templates (and refers to the template reporting requirements under

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[14] Although similar concerns in relation to implementing a complimentary direct approach in respect of the retention requirement did not prevent the EBA from making recommendation 1.

[15] Paragraph 1 of Article 405 shall not apply where the securitised exposures are exposures on or are fully, unconditionally and irrevocably guaranteed by the following entities:

(a) central governments or central banks;

(b) regional governments, local authorities and public sector entities of member states;

(c) institutions to which a 50% risk weight or less is assigned under Part Three, Title II of Chapter 2; or

(d) multilateral development banks.

[16] Paragraph 1 of Article 405 shall 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.

[17] *See* recommendation 5.

CRA3[18] and the ECB and Bank of England financing operations), however concludes[19] that the disclosure requirements are sufficiently comprehensive and "fit for purpose" to ensure investor protection and financial stability and recommends no changes.

- the due diligence requirements.

  The EBA considers the due diligence requirements under Article 406 of the Capital Requirements Regulation and notes that they significantly exceed what is required for other comparable investment products creating an uneven playing field. However, the EBA conclude[20] that the due diligence requirements are sufficient and appropriate to enable investors to conduct appropriate due diligence, justifying the burden of the requirements on the potential complexity of securitisation products.

- the adequacy of additional risk weight and administrative penalties/measures.

  Article 407 of the Capital Requirements Regulation provides that 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 addition, in accordance with Article 67(l) of CRD IV, member states must ensure that administrative penalties and other measures can be applied in situations where institutions are exposed to the credit risk of a securitisation without satisfying the conditions specified in Article 405 of the Capital Requirements Regulation.

  The EBA believes that the current sanctions in terms of additional risk weights and administrative penalties/measures are adequate and concludes[21] that no changes are required.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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[18] Regulation (EU) No. 462/2013 of 21 May 2013.

[19] *See* recommendation 7.

[20] *See* recommendation 8.

[21] *See* recommendation 9.