Clients&FriendsMemo

EBA's Draft EU Risk Retention Regulatory Technical Standards

31 July 2018

Introduction

On 31 July 2018, the European Banking Authority ("**EBA**") published its final draft Regulatory Technical Standards on the risk retention requirements[1] (the **"draft Risk Retention RTS"**) under the EU regulation intended to lay down common rules on securitisation and to create a European framework for "simple, transparent and standardised" securitisation (the "**Securitisation Regulation**").[2]

The December 2017 Consultation

The Draft Risk Retention RTS follow on from the draft RTS annexed to the **EBA's** consultation paper dated 15 December 2017 (the "**December Draft RTS**"), which were discussed in our Clients and Friends Memorandum dated 21 December 2017[3].

Legislative Background

The Securitisation Regulation was published in the Official Journal of the European Union on 28 December 2017 and "entered into force" on 17 January 2018. The Securitisation Regulation will be directly applicable law across the EU and will apply to securitisations, the securities of which are issued (or where no securities are issued, the securitisation positions of which are created), from 1 January 2019. We commented on the obligations that will arise under the Securitisation Regulation in our Clients and Friends Memorandum dated 26 October 2017[4].

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1 Draft Regulatory Technical Standards specifying the requirements for originators, sponsors and original lenders relating to risk retention pursuant to Article 6(7) of the Securitisation Regulation.

2 Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

3 https://www.cadwalader.com/uploads/cfmemos/6611b2cb78b3f7d724fe820e5dd7acfc.pdf

4 https://www.cadwalader.com/uploads/cfmemos/38ea3c254ddf2413acc355485d187ead.pdf

Legislative Basis of the Risk Retention RTS

Article 6 of the Securitisation Regulation contains the risk retention requirements. Article 6(7) of the Securitisation Regulation mandates that draft Risk Retention RTS are to be developed by the EBA, to specify in greater detail the risk retention requirement, in particular with regard to, *inter alia*: (a) the modalities for retaining risk; (b) the measurement of the level of retention; and (c) the prohibition of hedging or selling the retained interest.

The Current CRR Risk Retention RTS

As discussed in our Clients and Friends Memorandum dated 21 December 2017, the EBA has drafted the RTS with a view to ensuring that they follow, as far as possible, the rules set out in the current risk retention RTS[5] adopted pursuant to Article 410 of the Capital Requirements Regulation[6] regime (the "**Current CRR Risk Retention RTS**").

Comparison of the draft Risk Retention RTS with the December Draft RTS

Most of the provisions of draft Risk Retention RTS remain substantially unchanged from those discussed in our 21 December 2017 Clients and Friends Memorandum. In this memorandum we have focused on the principal changes to the December Draft RTS.

Minimum Risk Retention Levels

The current minimum risk retention level of 5% and the five different modes of risk retention have been maintained in the draft Risk Retention RTS.

Change of Retainer

The December Draft RTS allowed for a change in the retention holder in the limited circumstances in which it is unable to continue acting as such, due to the transfer of a direct or indirect holding in the retention holder, or for legal reasons beyond its control and beyond the control of its shareholders. This has now been moved to the recitals which state that where insolvency proceedings have been commenced in respect of the retainer or the retainer is, due to the transfer of a direct or indirect holding in the retainer or for legal reasons beyond its control and beyond the control of its shareholders, unable to continue acting as retainer, it should be possible for the remaining retained material net economic interest, instead, to be retained by another compliant entity, as long as the intention of the change of retainer is to continue to ensure the quality of the securitisation transaction and its attractiveness to investors. While this provision of the recitals is helpful, it obviously does not form part of the regulation itself and it is still unclear for example as to whether the removal of a CLO manager by investors would constitute a "legal reason beyond its control". This clarification does however provide some indication of the way in which

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5 Commission Delegated Regulation (EU) No 625/2014 of 13 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council by way of regulatory technical standards specifying the requirements for investor, sponsor, original lenders and originator institutions relating to exposures to transferred credit risk

6 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

regulators will apply the risk retention rules in these circumstances by emphasising the need to maintain the quality of the transaction and its attractiveness to investors.

"Originator" Definition for Risk Retention and the Sole Purpose Test

As we mentioned in our Clients and Friends Memoranda dated 26 October 2017 and 21 December 2017, the Securitisation Regulation definition of originator specifies that an entity shall not, for the purposes of risk retention, be considered to be an originator where it has been established or operates for the "sole purpose" of securitising exposures.

The December Draft RTS set out three conditions, which if satisfied, would mean that an entity would be deemed not to have been established, or to operate, for the "sole purpose" of securitising exposures, and so may constitute an originator for risk retention purposes. In response to feedback to its consultation, the EBA has moved to an even more principles-based approach in determining satisfaction of the "sole purpose" test by requiring consideration to be given to the entity's business strategy, capacity to meet payment obligations from sources other than the exposures being securitised or the retained interests, and the degree to which the entity's responsible decision makers have the required experience to pursue the established business strategy.

Prohibition of Hedging or Selling the Retained Interest and Retention Financing

The draft Risk Retention RTS clarify that the retained interest shall not be subject to any credit risk mitigation or hedging of either the retained securitisation positions or the retained exposures and that hedges of the net economic interest shall be permitted only where they do not hedge the retainer against the credit risk of such positions or exposures. The risk retainer is also not permitted to sell, transfer or otherwise surrender all or part of the rights, benefits, or obligations arising from the retained net economic interest. The draft Risk Retention RTS provide useful clarification in this regard in that retained exposures or securitisation positions may nevertheless be used for secured funding purposes including where the relevant funding arrangements involve a sale, transfer or other surrender of all or part of the rights, benefits or obligations arising from the retained net economic interest, as long as such use does not transfer the exposure to the credit risk of the applicable retained exposures or securitisation positions to a third party. This clarification is useful in the context of repo financing which is one method retainers rely on to finance their holding of the retained interest.

Risk Retention: Selection of Assets to be Securitised

The Securitisation Regulation provides that originators will not be permitted to select assets to be transferred to a securitisation special purpose entity ("SSPE") (i.e. to be securitised) with the aim of rendering losses on such assets, measured over the life of the transaction (or a maximum of four years where the life of the transaction is longer than 4 years), higher than the losses over the same period on "comparable" assets held on the balance sheet of the originator. Assets are deemed to be "comparable" if at the time of selection of the assets, the most relevant factors determining the expected performance of the assets are similar and if, as a result of such similarity,

it could reasonably have been expected on the basis of indications such as past performance or applicable models, that, over the applicable period, their performance would not be significantly different to the securitised assets. This prohibition does not however apply where the originator clearly communicates the higher than average expected credit risk profile on securitised relative to comparable non-securitised assets to investors. Where no such communication is made, the draft Risk Retention RTS provides that the regulator will consider certain factors in establishing the required "intent" of the originator including assessing any internal policies and procedures in place to ensure average expected credit risk profiles do not differ between securitised and comparable non-securitised assets. In addition, where no comparable assets exist, for example in the case of a CLO originator, the recitals of the draft Risk Retention RTS helpfully indicate that as long as this fact is communicated to investors, the applicable rule will be complied with.

Jurisdictional Scope of the "Direct" Obligation to Comply with the Risk Retention Requirements.

While the EBA regards the jurisdictional scope of the 'direct' retention obligation as outside the scope of the draft Risk Retention RTS, the EBA has acknowledged in the Feedback Statement which accompanies the draft Risk Retention RTS that a 'direct' obligation should apply only to originators, sponsors and original lenders established in the EU as suggested by the Commission in its explanatory memorandum. While the Feedback Statement does not form part of the draft Risk Retention RTS it is helpful guidance as to how the EBA views the jurisdictional scope of the Securitisation Regulation.

Consolidated Application of the CRR and Jurisdictional Consequences as regards risk retention

We mentioned in our Clients and Friends Memorandum dated 26 October 2017 that an issue that has caused widespread concern in the industry is the extent of the applicability of the risk retention obligations (and certain other obligations) in the Securitisation Regulation as a result of changes to the CRR. Article 1(11) of the CRR Amendment Regulation[7], which also applies from 1 January 2019, has the effect that Article 14 of the CRR applies the risk retention requirements (as well as the due diligence, transparency and "criteria for credit-granting" obligations, and the ban on re-securitisation) under the Securitisation Regulation to EU institutions subject to the CRR, on a consolidated basis. As a result of this amendment to Article 14 of the CRR, the direct risk retention obligation could therefore apply on a consolidated basis to a non-EU subsidiary of an EU bank. Such a subsidiary would have to comply both with the EU risk retention rules and with any locally applicable rules. These issues could have significant implications for EU banks operating in third countries through subsidiaries.

It appears that the application of the direct risk retention obligation to non-EU subsidiaries of EU banks was an unforeseen consequence of these changes to the CRR. Following intensive discussions with the EU institutions, it is expected that a further amendment will be made to

[7] Regulation (EU) 2017/2401 of the European Parliament and of the Council of 12 December 2017 amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms.

Article 14 of the CRR to address this issue as part of the overall package to amend the CRR known as "CRR II". The effect of the further amendment would be that Article 14 of the CRR would only apply the Securitisation Regulation's due diligence requirements (and not its risk retention or other obligations) on a consolidated basis.

However, it is not certain that CRR II will be adopted and come into force by the the application date of the Securitisation Regulation, 1 January 2019. It is therefore to be hoped that the EBA and national banking regulators in EU member states will grant forbearance as regards a strict enforcement of the consolidation rules in Article 14 of the CRR (save in respect of due diligence) in any period from 1 January 2019 until the amendment under CRR II comes into force. The EBA acknowledges in the Feedback Statement accompanying the draft Risk Retention RTS that it is engaging with the Commission and the co-legislators to raise awareness of the issue and that it shall provide the necessary support to assess the impact of Article 14 as it stands and to provide possible solutions to clarify and rectify the issue.

Next Steps

The Draft Risk Retention RTS will now be submitted to the European Commission which will adopt them in the form of a delegated EU regulation.

The Securitisation Regulation's transitional provisions state that until the Risk Retention RTS apply, originators, sponsors or the original lender must comply with the Current CRR Risk Retention RTS in respect of securitisations, the securities of which are issued on or after 1 January 2019. It is important that the Risk Retention RTS are adopted by the Commission in good time ready for their application on 1 January 2019, so as to avoid any potential complications that could arise from market participants having to comply with the Current CRR Risk Retention RTS after the application date of the new Securitisation Regulation regime.

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If you have any questions on these matters, please feel free to contact any of the Cadwalader attorneys below.

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