Clients&FriendsMemo

European Banking Authority Publishes Question and Answer Relating to Originator Risk Retention Holders in Securitisations

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Introduction

On 13 September 2019, the European Banking Authority (the "**EBA**") updated its guidance in respect of the Securitisation Regulation[1] by publishing an answer to a question submitted to it in November 2018 by the Association for Financial Markets in Europe ("**AFME**") in relation to Article 9(3) of the Securitisation Regulation. The EBA's answer provides guidance on how those undertaking securitisations may satisfy Article 9(3).

The Securitisation Regulation and credit-granting standards

Article 9(3) requires a person that securitises exposures[2] purchased for its own account from a third party (a "**limb (b) originator**") to verify that the entity which was directly or indirectly involved in the original agreement which created such exposures (the "**asset creator**") complied with the requirements of Article 9(1) of the Securitisation Regulation.[3]

Article 9(1) requires originators, sponsors and original lenders: (a) to apply to exposures to be securitised the same sound and well-defined criteria for credit-granting, and the same processes for approving, amending, renewing and refinancing such exposures, as they apply to non-securitised exposures; and (b) to have effective systems in place to apply such criteria and processes in order to ensure that credit-granting is based on a thorough assessment of creditworthiness.

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[1] Regulation (EU) 2017/2402

[2] Although Article 9 refers to exposures, the recitals to the Securitisation Regulation expressly provide that trade receivables which are not originated in the form of a loan do not need to meet credit-granting criteria.

[3] Article 9(4) provides that, in the case of exposures originated prior to 20 March 2014, the verification requirement in Article 9(3) does not apply if the limb (b) originator instead itself obtains all the necessary information to assess whether the criteria applied in the credit-granting for the securitised exposures are as sound and well-defined as the criteria applied to non-securitised exposures. However, Article 9(4) has increasingly little application as almost all securitisations being undertaken now and in the future involve exposures originated more recently than 20 March 2014.

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Article 9(1), through the references to "sound and well-defined" criteria and ensuring that credit-granting is based on a thorough assessment of creditworthiness has a second aspect requiring a minimum standard applicable to how exposures are originated and dealt with. Market practices regarding origination differ significantly between different types of exposure, reflecting differences in size, duration and collateralisation between different types of exposures. However, Article 9(1) doesn't acknowledge the possibility of differences between what is required for different types of exposures or refer to market practice.

AFME's question to the EBA

AFME's question to the EBA requested guidance regarding how a limb (b) originator may in practice comply with the verification requirement of Article 9(3) in certain circumstances, including:

- where the asset creator is not involved in the securitisation and therefore has no incentive to cooperate in the completion of this verification, *e.g.* in the case of managed CLOs;
- where the asset creator no longer exists at the time of the securitisation;
- where the exposures to be securitised have been transferred multiple times since their creation; or
- where the length of time between the origination of the exposures and the securitisation is such that that the information necessary to complete the verification no longer exists.

AFME noted that one of the purposes of the introduction of the requirements in Article 9 of the Securitisation Regulation was to protect against the "originate to distribute" model which was seen prior to the 2008 financial crisis by preventing originators, sponsors and original lenders from creating exposures which they know to be of lesser quality specifically for the purpose of securitising such exposures and passing the credit risk to the securitisation investors. AFME recommended that EBA provide a more "*nuanced and contextualised interpretation of Article 9(3)*", taking into account the circumstances of each securitisation transaction.

The EBA's answer

In its answer to AFME's question, the EBA agreed with AFME that one purpose of Article 9(1) is to "*prevent that exposures of lower credit quality are created with the sole purpose of being securitised*" and that Article 9(3) should be interpreted in line with such purpose and "*appropriately to the class of assets being purchased and the nature and type of securitisation*".

The EBA further stated that verification as used in Article 9(3) should mean that the limb (b) originator should ascertain "*through any appropriate means*" that the relevant asset creator did not apply different underwriting criteria for assets being securitised than those it applies to assets it holds on its balance sheet. In terms of the standard of the verification process, the EBA suggests that an originator should "*use adequate resources and make reasonable efforts to obtain as much information as is available and appropriate for such verification in accordance*

with sound market standards of due diligence for the class of assets and the nature and type of securitisation."

Interpreting the EBA's answer

The EBA's answer does not directly address the concerns raised by the market and certainly does not provide any bright line test. In particular, it is apparent that the EBA and national regulators will expect limb (b) originators to have evidence that some form of verification process as to credit standards has taken place. It is difficult to be certain how much verification is required as the EBA has not provided any specific guidance on the scenarios raised by market participants.

That said, there are two points which we take from the EBA's answer.

First, the EBA said that the obligation to verify should be interpreted as consistent with purpose of preventing exposures of lower credit quality from being created with the sole purpose of being securitised. This implies that verifying that the credit-granting criteria and processes applicable to securitised exposures were not lower than they would otherwise have been on account of an intention or expectation that the exposures would be securitised is more important than verifying that such criteria and processes satisfy any minimum standard. In many cases it will be clear that at the time of origination the asset creator had no knowledge that the particular exposures being securitised would be the ones subsequently sold and securitised compared with other exposures originated at the same time that were ultimately retained by the asset creator, such that the asset creator could not have applied different credit-granting criteria and processes to the securitised exposures compared with other exposures originated by the asset creator.

Secondly, the EBA said that the verification required by Article 9(3) should be undertaken "*in accordance with sound market standards of due diligence for the class of assets and the nature and type of securitisation*". This makes it clear that the level of verification necessary to satisfy Article 9(3) is not uniform across all securitisations but may vary at least to some degree based on the type of the securitised exposures and the type of the securitisation.

Approaches to compliance with the verification requirement under Article 9(3) in CLO transactions

European CLO transactions and US broadly-syndicated CLO transactions involve a collateral manager, on behalf of the CLO, acquiring loans in individual transactions from market sellers. Where the collateral manager or a third party is to act as retention holder for the purpose of satisfying the retention requirement under Article 6 of the Securitisation Regulation, the collateral manager or such third party will need to qualify as a sponsor or originator and most commonly does through being a limb (b) originator of some of the loans included in the CLO and is thus subject to the verification requirement under Article 9(3) in relation to such loans.

Where the asset creator of a loan is an EU credit institution authorised under the Capital Requirements Regulation,[4] a limb (b) originator should be able to take comfort that the loan was originated in line with Article 9(1). Article 408 of the Capital Requirements Regulation, using identical wording to that in Article 9(1), requires credit institutions to apply the same criteria for credit-granting, and the same processes for approving, amending, renewing and refinancing credits, to exposures to be securitised as they apply to exposures to be held in their own non-trading book. In addition, with effect from 30 June 2020 credit institutions will be required to comply with EBA guidelines on loan origination and monitoring. A limb (b) originator determining that the asset creator is an EU credit institution could be regarded as the verification that the asset creator complied with Article 9(1) "*in accordance with sound market standards of due diligence for the class of assets and the nature and type of securitisation*", at least where such limb (b) originator is not aware of any breach by the asset creator of its regulatory obligations under the Capital Requirements Regulation.

A loan in a CLO transaction almost always comprises only a portion of a syndicated leveraged loan with multiple lenders of which the CLO issuer is only one. Where there are multiple initial lenders under such a loan the terms of the loan will be negotiated by the initial lenders collectively and it would be difficult for a single initial lender to apply a lower credit standard to such a loan compared with loans it originates and retains. Even if such a loan has a single initial lender such initial lender will have originated the loan in contemplation of syndication shortly after origination and therefore have in contemplation the credit standards which prospective syndicate lenders will require. Finally, initial lenders of such loans do not customarily have different origination processes for those leveraged loans which they syndicate compared with those leveraged loans which they do not. As such a limb (b) originator might, having regard to the EBA's answer, consider that the information which it has regarding the origination and syndication of a syndicated leveraged loan is such that initial lender must have applied to the same credit-granting criteria and processes to such loan as the initial lender does to other leveraged loans which it originates.

As regards any minimum standard of origination required by Article 9(1) and to be verified by a limb (b) originator under Article 9(3), a collateral manager on a CLO transaction that is a limb (b) originator that receives full information in relation to the borrower under a syndicated leveraged loan, whether because the borrower is a listed corporate or because such information is made available to it under the terms of the loan agreement, may take the view that it is in a position to assess whether the asset creator carried out a thorough assessment of the obligors' creditworthiness.

US securitisations

The obligation to comply with Article 9(3) does not apply directly to US based limb (b) originators. The investor due diligence requirements do, however, apply to EU based investors in relation to their investment in a non-EU securitisation. Article 5(1)(b) requires that such

[4] Regulation (EU) No 575/2013

investors verify that a non-EU originator or "*original lender*" has granted credit "*on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits and has effective systems in place to apply those criteria and processes to ensure that credit-granting is based on a thorough assessment of the obligor's creditworthiness*". This is a repetition of the requirements as to credit-granting in Article 9.

It follows that EU institutional investors are required to carry out a similar task in relation to an assessment of credit-granting standards for assets in a non-EU securitisation as to assets in a an EU securitisation, although this point is not explicitly referenced in the Q&A. Nonetheless, US originators will expect to be faced with more detailed questions about credit-granting procedures, although the simplifying factors as to market practice and asset classes mentioned above could apply to some non-EU markets such as the United States.

Brexit

The Q&A are non-binding and have no legal status in EU financial services law, although in practice the responses carry considerable weight with national regulators and market participants.

In preparation for Brexit, the UK Treasury has proposed to "on-shore" all EU financial services laws into UK law, through the EU (Withdrawal) Act 2018. Under this Act, however, non-legislative material produced by European Supervisory Authorities (such as the EBA) will not be incorporated into UK law, even though the EU-derived law to which that material relates will be retained. The UK regulators have stated that they will continue to have regard to EU non-legislative material (such as the Q&As) where relevant, and have advised that participants and stakeholders should also continue to do so.

The Article 9(3) obligation and the associated Q&A will therefore continue to have relevance for UK and EU27 firms post-Brexit.

Conclusion

The Q&A response does not create a bright line test for when extensive verification of credit-granting standards will be necessary, or any clear instructions or gradations for the level of verification required for particular asset classes or in particular jurisdictions. It seems clear that a limb (b) originator will have to make "reasonable efforts" to obtain as much information as possible about the relevant credit-granting standards. The Q&A response contemplates, however, that the nature and detail of the information to be sought can and will vary across different asset classes and in different securitisation scenarios.

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