Risk retention in EU and UK securitisations

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This Practice Note describes the position as at January 2021

What is risk retention?

Risk retention in the EU and the UK

The risk retention requirement currently applicable in the EU and the UK consists of obligations on:

- an EU or UK (as applicable) institutional investor to ensure that the originator, sponsor or original lender of a securitisation retains at least 5% of the net economic interest of any securitisation in which it invests, and
- one of the originator, sponsor or original lender to retain a net economic interest of at least 5%

This is explained in more detail below.

The objective of the risk retention requirement

The objective of the risk retention requirement is to create an alignment of interests between those of the suppliers of a securitisation, ie sponsors, originators and original lenders, and those of investors. It is sometimes referred to as the requirement for 'skin-in-the-game'.

International background

References:

G20 Leaders' Statement, The Pittsburgh Summit, 24–25 September 2009

The introduction of the risk retention requirement reflected the criticism of the securitisation markets following the global financial crisis. There was widespread concern about the 'originate to distribute' model in which banks did not hold the loans that they originated, but repackaged and securitised them. It was thought by global policymakers that some of the participants in the securitisation chain were incentivised to engage in behaviour which, while furthering their own interests, was not in the interests of others in the securitisation chain or of the broader market. In the 'originate to distribute' model lenders did not have an incentive to apply stringent credit granting standards, since they knew that the related risks would eventually be sold to third parties. A consequence of these misaligned incentives or conflicts of interest led to a weakening of due diligence along the securitisation chain. This resulted in poorly-underwritten assets being securitised by originators and those securities being bought by investors who did not always understand the extent of the risks that they were acquiring. The G20 Leaders' statement from the 2009 Pittsburgh Summit therefore recommended that securitisation 'sponsors or originators should retain a part of the risk of the underlying assets, thus encouraging them to act prudently'.

Introduction of risk retention in the EU

References:

Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management

Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013

A 5% risk retention requirement was first introduced in the EU (including, at the time, the UK) by way of the Capital Requirements Directive II to new securitisations issued on or after 1 January 2011. These provisions were superseded by an equivalent requirement in the Capital Requirements Regulation (EU) No 575/2013 (EU CRR) and similar to those in the EU CRR, in the Solvency II regime in relation to insurers and in the Alternative Investment Fund Managers Directive (AIFMD) regime in relation to certain alternative fund managers.

Commission Delegated Regulation (EU) No 625/2014 (the CRR Risk Retention RTS) supplements and provides further detail in respect of the risk retention requirement in the EU CRR by way of regulatory technical standards including providing further detail on the modes of risk retention, the fulfilment of the retention requirement through a synthetic or contingent form (eg a total return swap (TRS)), and on multiple originators, original lenders, or sponsors.

The European Commission (EC), following review of the various requirements applicable to EU securitisations, published Regulation (EU) 2017/2402 on 28 December 2017 (the EU Securitisation

Regulation) and an accompanying Regulation amending the EU CRR (the EU CRR Amendment Regulation). These regulations entered into force on 17 January 2018, superseding the EU CRR, Solvency II and AIFMD risk retention requirements, largely combining requirements applicable to EU investors and creating new requirements in respect of originators, sponsors or original lenders of EU securitisations, and applicable to securitisations, the securities of which are issued (or where no securities are issued, the securitisation positions of which are created) on or after the application date of 1 January 2019.

Article 6(7) of the EU Securitisation Regulation requires the European Banking Authority (EBA) to develop draft regulatory technical standards (Securitisation Regulation RTS) to specify in greater detail the risk retention requirement including the modalities of retaining risk, the measurement of the level of retention, the prohibition of hedging or selling the retained interest and the conditions for retention on a consolidated basis. On 31 July 2018, a final draft of the Securitisation Regulation RTS was published by the EBA. However, the draft Securitisation Regulation RTS have not yet been adopted by the EC. The transitional provisions of the EU Securitisation Regulation provide that until the draft Securitisation Regulation RTS apply, originators, sponsors or the original lender shall apply Chapters I, II and III and Article 22 of the CRR Risk Retention RTS to securitisations the securities of which are issued on or after 1 January 2019.

For more information on the Solvency II regime, see Practice Notes: Solvency II—essentials and Solvency II—one minute guide, and for more information on the AIFMD regime, see Practice Notes: AIFMD—essentials and AIFMD—one minute guide.

For more information on the Securitisation Regulation, see: Securitisation Regulation—timeline and Practice Note: European regulation of structured products and securitisation—one minute guide.

The Securitisation Regulations and Brexit

Following the UK's withdrawal from the EU, the EU Securitisation Regulation has been transposed into English law by virtue of the European Union (Withdrawal) Act 2018 (the Withdrawal Act), and amended by the Securitisation (Amendment) (EU Exit) Regulations 2019 of the UK, SI 2019/660 (the UK Securitisation Regulation—Retained Regulation (EU) 2017/2402 and together with the EU Securitisation Regulation, the Securitisation Regulations).

The Explanatory Memorandum to the Securitisation (Amendment) (EU Exit) Regulations 2019, SI 2019/660 (the Explanatory Memorandum) confirms that responsibility for making Binding Technical Standards under the UK Securitisation Regulation will be transferred to the UK Prudential Regulation Authority (PRA) and the UK Financial Conduct Authority (FCA) as appropriate. It therefore remains to be seen whether the UK Securitisation Regulation will adopt the draft Securitisation Regulation RTS or whether the FCA and PRA will diverge from such RTS at the time of implementation.

For more information on Brexit, see Practice Note: Brexit—introduction to the Withdrawal Agreement. For further guidance, see Practice Notes: Brexit—impact on finance transactions—Brexit planning and impact—financial services, Brexit—impact on finance transactions—Key issues for securitisation transactions, Brexit—impact on finance transactions—Derivatives and debt capital markets transactions—key SIs, and Quick Look Brexit Financial Services Legislation Status Guide—Securitisation Regulation.

Risk retention under the Securitisation Regulations

The 'indirect' and 'direct' approaches to risk retention

Prior to holding a securitisation position, under Article 5 of the EU Securitisation Regulation, EU 'institutional investors', and, under Article 5 of the UK Securitisation Regulation, UK 'institutional investors' (in each case, other than when acting as an originator, a sponsor or original lender), are required to verify that the originator, sponsor or original lender retains on an ongoing basis a 'material net economic interest' which, in any event, shall not be less than 5%. EU institutional investors must therefore carry out due diligence on non-EU entities and UK institutional investors must therefore carry out due diligence on non-UK entities, in each case to ensure that they meet a retention requirement broadly equivalent to that imposed on EU or UK established entities (as applicable). Therefore, even if none of the originator, sponsor or original lender is established in the EU (in the case of EU institutional investors) or the UK (in the case of UK institutional investors), and so none of them is subject to the EU or the UK (as applicable) direct retention obligation, one of them will still need to comply with equivalent requirements in order for such institutional investors to be able to invest in the securitisation. This is known as the 'indirect' risk retention obligation as it

on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance

Commission Delegated Regulation (EU) 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision

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

References:

Article 6(7) of Regulation (EU) 2017/2402

Article 22 of Regulation (EU) 625/2014

References:

European Union (Withdrawal) Act 2018

Securitisation (Amendment) (EU Exit) Regulations 2019, SI 2019/660 Retained Regulation (EU) 2017/2402

References:

Explanatory Note to the Securitisation (Amendmnent) (EU Exit) Regulations 2019, SI 2019/660

places an onus on the investing institutions to ensure that the originator, sponsor or original lender retains at least 5% of the net economic interest of any securitisation in which it invests.

Under Article 6 of the Securitisation Regulations, one of the originator, sponsor or original lender is required retain a net economic interest of at least 5% in the securitisation. This is known as the 'direct' risk retention obligation as it places the onus on the originator, sponsor or original lender to retain.

References:

Article 5 of Regulation (EU) 2017/2402

Article 5 of Retained Regulation (EU) 2017/2402

What are the securitisations to which this obligation applies?

In the Securitisation Regulations, 'securitisation' refers to a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is 'tranched' and where:

- payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures, and
- the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme

Tranching refers to contractually established segments of the credit risk associated with the exposures, each containing different risks of credit loss.

References:

Article 6 of Regulation (EU) 2017/2402

Article 6 of Retained Regulation (EU) 2017/2402

Who retains the risk?

Under the Securitisation Regulations, the retention must be held by the originator, sponsor or original lender.

A 'sponsor' is an 'institution' (ie a 'credit institution' or CRR investment firm) (other than an originator) that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third-party entities.

'Original lender' is not defined in the CRR, although it is defined in the new Securitisation Regulation in which it has the same meaning as a limb (a) originator (see below).

Who is an 'originator'?

An 'originator' is an entity which:

- itself (or through related entities), directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor (or potential debtor) giving rise to the exposure being securitised, or
- purchases a third party's exposures for its own account and then securitises them

References:

EBA report on securitisation risk retention, due diligence and disclosure

In addition, an entity shall not be considered to be an originator where it has been established or operates for the 'sole' purpose of securitising exposures (Article 6(1) of the Securitisation Regulations). This is to avoid the possibility of an 'originator' being created for risk retention purposes that meets the legal definition, but is not an entity of real substance. This possibility was first raised in the EBA report of December 2014 on securitisation risk retention, due diligence and disclosure, in which it reviewed the operation of risk retention in the securitisation markets.

References:

Article 6(1) of Regulation (EU) 2017/2402

Article 6(1) of Retained Regulation (EU) 2017/2402

The meaning of 'sole purpose' has been clarified in the draft Securitisation Regulation RTS (Article 3(6) of the draft Securitisation Regulation RTS) which provides that, in assessing whether an entity has been established or operates, for the 'sole purpose' of securitising exposures, appropriate consideration shall be given to two principles:

- the entity has a business strategy and the capacity to meet payment obligations from sources other than the exposures being securitised or retained interests, consistent with a broader business enterprise, and
- the responsible decision makers have the required experience to enable the entity to pursue the established business strategy, as well as an adequate corporate governance arrangement

Who is a 'sponsor'?

Under the EU Securitisation Regulation, 'sponsor' means a credit institution, whether located in the Union or not, as defined in point (1) of Article 4(1) of the EU CRR, or an investment firm as defined in point (1) of Article 4(1) of Directive 2014/65/EU other than an originator, that: (a)

establishes and manages an asset-backed commercial paper programme or other securitisation that purchases exposures from third-party entities, or (b) establishes an asset-backed commercial paper programme or other securitisation that purchases exposures from third-party entities and delegates the day-to-day active portfolio management involved in that securitisation to an entity authorised to perform such activity in accordance with Directive 2009/65/EC, Directive 2011/61/EU or Directive 2014/65/EU.

Under the UK Securitisation Regulation, 'sponsor' means a credit institution as defined in point (1) of Article 4(1) of the EU CRR or an investment firm as defined in paragraph 1A of Article 2 of Regulation 600/2014/EU, whether located in the UK or in a third country, which—(a) is not an originator; and (b) either—(i) establishes and manages an asset-backed commercial paper programme or other securitisation that purchases exposures from third party entities; or (ii) establishes an asset-backed commercial paper programme or other securitisation that purchases exposures from third party entities and delegates the day-to-day active portfolio management involved in that securitisation to an entity which is authorised to manage assets belonging to another person in accordance with the law of the country in which the entity is established.

References:

Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directive 2003/41/EC, Directive 2009/65/EC, Regulation (EC) No 1060/2009 and Regulation (EU) No 1095/2010 Article 4(1) of Regulation (EU) 575/2013

The definition of 'sponsor' for the purposes of the EU Securitisation Regulation includes 'investment firms' as defined in MiFID II. The MiFID II definition of investment firm is not limited by jurisdiction and so, on a literal interpretation of the EU Securitisation Regulation, it appears that non-EU entities could also act as sponsors. However, it is not clear that this was the legislators' intention and this point remains unclear. As referenced in the Explanatory Memorandum, the UK Securitisation Regulation definition of 'sponsor' seeks to address this ambiguity as regards the location of sponsors by specifically including the words 'whether located in the United Kingdom or in a third country' in respect of investment firms and so under the UK Securitisation Regulation it is clear that a sponsor may be located in any country.

Who is an 'original lender'?

An 'original lender' is an entity which (itself or through related entities) directly or indirectly concluded the original agreement which created the obligations (or potential obligations) of the debtor (or potential debtor) giving rise to the exposures being securitised (Article 2(20) of the Securitisation Regulations). This is similar to limb (a) of the originator definition above.

References:

Article 4(1) of Regulation (EU) 575/2013

Changer of retainer

The recitals to the draft Securitisation Regulation RTS (see recital 13) 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, provided that 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 statement in the recitals is helpful, it does not form part of the operative provisions of the draft Securitisation Regulation RTS, and it is still unclear, for example, as to whether the removal by investors of an investment manager of a securitisation for reasons not relating to risk retention would constitute a 'legal reason beyond its control'. This statement does, however, provide some indication of the way in which European 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.

References:

Article 2(20) of Regulation (EU) 2017/2402

Article 2(20) of Retained Regulation (EU) 2017/2402

How is the risk retained?

There are five permitted ways in which a material net economic interest of not less than 5% may be retained. Retainers must hold the retained interest using one holding option only; combinations of holding options are not permitted.

- retention of no less than 5% of the nominal value of each of the tranches sold or transferred to the investors (sometimes called retention of a 'vertical' slice)
- in the case of revolving securitisations or securitisations of revolving exposures, the retention of the originator's interest of not less than 5% of the nominal value of each of the securitised exposures
- the retention of randomly selected exposures equivalent to not less than 5% of the nominal value of the securitised exposures in the securitisation, provided that the

number of potentially securitised exposures is not less than 100 at origination

- the retention of the first loss tranche and, where such retention does not amount to 5% of the nominal value of the securitised exposures, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total not less than 5% of the nominal value of the securitised exposures (sometimes called retention of a 'horizontal' slice)
- the retention of a first loss exposure of not less than 5% of every securitised exposure in the securitisation

Features of the retained net economic interest

The interest is measured at the origination and is determined by the notional value for off-balance-sheet items. Where the originator, sponsor or original lender have not agreed between them who will retain the material net economic interest, the originator has to retain. There can be no multiple applications of the retention requirements for any given securitisation. The material net economic interest cannot be split amongst different types of retainers and it cannot be subject to any credit-risk mitigation or hedging (Article 6(1) of each of the Securitisation Regulations) but hedges of the net economic interest are permitted where they do not hedge the retainer against the credit risk of either the retained securitisation positions or the retained exposures.

References:

Article 6(1) of Regulation (EU) 2017/2402

Article 6(1) of Retained Regulation (EU) 2017/2402

Jurisdictional scope of the direct risk retention obligation

The Securitisation Regulations do not explicitly set out the jurisdictional scope of the 'direct' risk retention requirement. It appears from a comment in the Explanatory Memorandum to the original Commission proposal that the intention is that where none of the originator, sponsor or original lender is 'established in the EU', the direct approach will not apply. Furthermore, in the Feedback on the public consultation which accompanied the draft Securitisation Regulation RTS (the Feedback Statement), the EBA stated that it:

> '…agrees however that a "direct" obligation should apply only to originators, sponsors and original lenders established in the EU as suggested by the Commission in the explanatory memorandum'

This comment from the EBA provides helpful clarification on this point. However, the jurisdictional scope is not expressly set out in the text of either the EU Securitisation Regulation or in the draft Securitisation Regulation RTS.

Following the UK's departure from the EU, guidance given by the EBA in respect of regulations (such as the EU Securitisation Regulation) transposed into English law do not apply to the relevant UK transposed regulation. In respect of the interpretation of regulations such as the UK Securitisation Regulation however, the FCA and PRA have indicated that they will continue to have regard to EU non-legislative materials (such as the EBA interpretation above) where and if they are relevant, taking account of the UK's departure from the EU and ongoing domestic legislation.

As regards EU banks operating in non-EU countries in the case of the EU Securitisation Regulation and UK banks operating outside of the UK in the case of the UK Securitisation Regulation, Regulation (EU) 2019/876 (which also forms part of the UK domestic law by virtue of the Withdrawal Act (as amended)) states that only Article 5 of the Securitisation Regulations will apply to parent and subsidiary undertakings on a consolidated basis and therefore such entities operating in non-EU countries or outside of the UK (as applicable) are not subject to the 'direct' risk retention requirement.

References:

Proposal for a Regulation of the European Parliament and of the Council laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation and amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 EBA Final Draft Regulatory Technical Standards (including the Feedback Statement) Regulation (EU) 2019/876

Role of the ESRB and the potential for a revision of minimum risk retention levels

The EU Securitisation Regulation contains provisions empowering the European Systemic Risk Board (ESRB) to provide warnings where material financial stability risks are observed and, where appropriate, issue recommendations for remedial action, including on the appropriateness of modifying the risk-retention levels (Article 31 of the EU Securitisation Regulation). It is therefore possible that the minimum risk retention levels could increase in the future.

The UK Securitisation Regulation does not include a provision equivalent to Article 31 of the EU

References:

Article 31 of Regulation (EU) 2017/2402

Securitisation and, while the FCA and PRA have indicated that they will continue to have regard to EU non-legislative materials (where and if they are relevant, taking account of the UK's departure from the EU and ongoing domestic legislation), any recommendations from the ESRB incorporated into the EU Securitisation Regulation may not be incorporated into the UK Securitisation Regulation.

Administrative sanctions or penalties

Article 32 of the EU Securitisation Regulation requires Member States to impose administrative sanctions for a breach of the risk retention requirement, in the case of 'negligence or intentional infringement' (this is without prejudice to the right for Member States to impose criminal sanctions).

References:

Article 32 of Regulation (EU) 2017/2402

The UK Securitisation Regulation omits Article 32 of the EU Securitisation Regulation and therefore contraventions of the UK Securitisation Regulation will be assessed by, and may result in administrative penalties being imposed on any relevant party, by the FCA or PRA in each case. As a result there is no requirement for negligence before any such penalties are imposed and the FCA or PRA (as applicable) will assess any contraventions in accordance with its usual enforcement powers.

Selection of assets to be securitised—'cherry picking' assets

The Securitisation Regulations provide that originators will not be permitted to select assets to be transferred to a securitisation special purpose entity (SSPE) (ie 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 four years), higher than the losses over the same period on 'comparable assets' held on the balance sheet of the originator (Article 6(2) of the Securitisation Regulations).

References:

Article 6(2) of Regulation (EU) 2017/2402

Article 6(2) of Retained Regulation (EU) 2017/2402

This is intended to prevent originators from taking advantage of the fact that they could hold more information in respect of the assets than investors. The recitals to the EU Securitisation Regulation note that this is intended to catch an intentional (rather than a negligent) transfer of assets with a higher credit risk profile

The recitals also provide athat the assets being securitised can have a higher than average credit risk profile compared with the average credit risk profile of comparable assets that remain on the balance sheet of the originator, as long as the higher credit risk profile of the assets is 'clearly communicated' to the investors or potential investors (recital 11 to the EU Securitisation Regulation).

In addition, the rectials to the draft Securitisation Regulation RTS clarify that the prohibition on adverse selection should not apply where there are no comparable assets against which to perform such a comparison exercise, provided that this is clearly communicated to the investors (recital 12 of the draft Securitisation Regulation RTS).

As for which assets will be deemed to be 'comparable' for the purposes of selection, the draft Securitisation Regulation RTS (Article 16(1) of the draft Securitisation Regulation RTS) state that it is those assets which at the time of selection, meet the following two conditions:

- the most relevant factors determining the expected performance of the assets are similar, and
- as a result of this similarity, it could reasonably have been expected, on the basis of indications such as past performance or applicable models, that, over the time period set out in Article 6(2) of the Securitisation Regulations (ie the life of the transaction, or over a maximum of four years where the life of the transaction is longer than four years) their performance would not be significantly different

References:

Article 6(2) of Regulation (EU) 2017/2402

Article 6(2) of Retained Regulation (EU) 2017/2402