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EU Risk Retention Requirement: A Brief Overview of the Current Framework

JEREMIAH WAGNER, NICK SHIREN, AND PATRICK LEFTLEY

This article gives a broad overview of the current EU risk retention regime as set out in the Capital Requirements Regulation (Regulation (EU) No 575/2013) (the "CRR") and associated guidance published by the European Banking Authority (the "EBA") and compares the current regime with the previous regime set out in Article 122a of the Banking Consolidation Directive 2006/48/EC ("Article 122a"), including certain transaction-specific considerations.

In response to the perceived failings of the securitisation industry in the aftermath of the financial crisis, the European risk retention regime was introduced by the package of legislation known as "CRD II," which came into force on January 1, 2011.[1] In particular, Article 122a required credit institutions to conduct due diligence on investments in securitisations and only to invest where a five percent material net economic interest was retained by those involved in their establishment.[2]

Among the stated aims of Article 122a was the desire to remove "the misalignment between the interest of firms that 're-package' loans into tradable securities and other financial instruments…and firms that invest in these securities or instruments."[3] In the preamble to the Capital Requirements Regulation (the "CRR"), the replacement for Article 122a, a similar aim is

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set out that "the interest of undertakings that 're-package' loans into tradable securities and other financial instruments…and undertakings that invest in these securities or instruments are aligned."[4] Despite broad similarities between the Article 122a and CRR regimes, there are significant differences of which participants in the securitisation industry should be aware and which are likely to have a meaningful impact on the structure and viability of certain transactions.

Article 122a, together with the accompanying guidance provided by the Committee of European Banking Supervisors and its successor, the EBA (the "122a Guidance")[5] have been and will be replaced respectively by the CRR as of January 1, 2014 and by the EBA's Final Draft Regulatory Technical Standards (the "RTS") and Final Draft Implementing Technical Standards (the "ITS" and together with the RTS the "Final Draft EBA Standards") in the first half of 2014 pending final adoption and approval by the EU Commission, the EU Parliament and the Council of the European Union.[6] The Final Draft EBA Standards have been subject to an iterative consultation process and it is unlikely that they will be modified significantly before final adoption.

RISK RETENTION UNDER THE CRR

Scope[7]

The CRR regime applies to credit institutions and investment firms investing in, or acting as originator, sponsor or original lender with respect to, securitisations issued on or after January 1, 2011, or any securitisation issued prior to that date where new assets are added or substituted after December 31, 2014.[8]

"Securitisation," in this context, is widely defined to cover "any transaction or scheme whereby the credit risk associated with an exposure or pool of exposures is tranched," within certain parameters.[9] As a result, many more transactions than those that would traditionally be considered "securitisations" potentially fall within the scope of the CRR regime. For example, secured transactions featuring mezzanine or subordinated lending could fall within the definition, although this will vary depending on the precise features of each transaction.[10]

The key requirements of the CRR vary depending on the role of the credit institution or investment firm in the securitisation. In the case of investors, the principal requirements are that they (a) only invest in securitisations where a five percent net economic interest has been retained by the originator, sponsor or original lender, and (b) conduct comprehensive due diligence in respect of such investments.[11] In the case of originators, sponsors and original lenders, the principal requirements are (a) the application of sound credit granting criteria during the origination process, and (b) the disclosure of information to investors in the securitisation.[12]

REQUIREMENTS FOR INVESTING FIRMS

Risk Retention — Who Retains?

The five percent retention must be held by an originator, sponsor or original lender. Broadly, an originator is an entity involved in creating the underlying exposures or in acquiring them for the purposes of then securitising them, a sponsor is a credit institution or investment firm that establishes or manages the securitisation and an original lender is an entity involved in creating the underlying exposures other than a sponsor.[13]

This base position is expanded on in the Final Draft EBA Standards. In particular, these clarify that the retention may be held by multiple originators, sponsors or original lenders, but not by a combination of those categories.[14] In the case of retention by multiple originators or multiple original lenders, the retention must be held either (a) *pro rata* to their contribution to the pool of securitised assets, or (b) by a single originator or original lender provided that such entity has established the securitisation and either (i) is managing the securitisation, or (ii) has contributed over 50 percent of the total pool of securitised assets. In the case of transactions with multiple sponsors, retention can be fulfilled either (a) on a *pro rata* basis according to the number of sponsors or, (b) by a single sponsor whose interest is most appropriately aligned with investors.[15]

What Must Be Retained?

The originator, sponsor or original lender fulfilling the retention requirement must hold a material net economic interest of not less than five percent in the securitisation. The CRR limits a "material net economic interest" to five qualifying forms, only one of which can be used in conjunction with any given transaction.[16] These comprise retention of not less than five percent of the following:

- the nominal value of each of the tranches sold or transferred to the investors;

  This equates to a "vertical slice" through the capital structure. The Final Draft EBA Standards clarify that this can be satisfied by holding a single vertically tranched note of the requisite nominal value. They also note that, in the context of asset-backed commercial paper ("ABCP") programmes, this form of retention may be satisfied by certain qualifying liquidity facilities.[17]

- in the case of securitisations of revolving exposures, the originator's interest of the nominal value of the securitised exposures;

  This option has the potential to be useful in a variety of structures. The Final Draft EBA Standards have clarified that a retained originator interest must rank *pari passu* with, or be subordinated to, the credit risk securitised for the same exposures.[18]

- the nominal value of the securitised exposures, composed of randomly selected exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is no less than 100 at origination;

  This form of retention should effectively equate to retention of a pool of assets of comparable credit profile to the securitised pool and is accordingly limited to larger asset pools to avoid distortion caused by non-granular assets. The Final Draft EBA Standards make clear that, if necessary because the securitisation is of a revolving pool of assets or of assets whose nominal value fluctuates over time, the retainer may designate different assets as being retained during the life of the transaction.[19] This was not clear under the 122a Guidance and is a welcome clarification.

- the nominal value of the securitised exposures, composed of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors;

  This equates to a "horizontal slice" across the first loss tranche or tranches. The Final Draft EBA Standards expand on this and contemplate a variety of forms that would satisfy this retention method, including the extension of a guarantee or letter of credit to the securitisation by the retainer, overcollateralisation or the provision of a qualifying liquidity facility in the context of an ABCP programme. In cases where the first loss tranche exceeds five percent of the nominal value of all securitised exposures, it is not necessary to retain the whole of such tranche but only enough to reach the five percent threshold.[20]

- a first loss exposure of every securitised exposure in the securitisation.[21]

  This form of retention involves separately retaining the first loss piece of each securitised asset. The Final Draft EBA Standards clarify that the retained exposures must at all times be subordinated to the credit risk of the securitised exposures. They further clarify that an appropriate discount on the sale of the assets into the securitisation can satisfy this retention method.[22] So for example, a 95 percent advance rate on the sale of all receivables or a five percent deferred purchase price on sales at par value would seem to fall within the guidance. This is a new option in the CRR and is discussed in further detail below.

The retention requirements refer to the "nominal value" of the securitisation tranches or the securitisation exposures. The Final Draft EBA Standards clarify that nominal value is distinct from acquisition price, so for example for a pool of assets of par 100 sold into the securitisation at an advance rate of 95 percent, the net economic interest to be retained is five, not 4.75.[23] They also state that the calculation is a dynamic one and is based only on amounts actually advanced (excluding, for example, undrawn commitments under a credit card), making it clear that the amount required to be retained may fluctuate during the life of a transaction.[24]

What Does It Mean to Retain?

Under the CRR, the retained five percent interest must be held on an "ongoing basis," and cannot be sold, nor the associated credit risk hedged or otherwise mitigated.[25] The Final Draft EBA Standards add that neither the method of retention nor the method of calculating the retained amount may be changed during the life of the transaction otherwise than in exceptional circumstances.[26]

The prohibition on various forms of disposition of the retained interest contained in the CRR is subject to exemptions set out in the Final Draft EBA Standards for (a) hedges that do not transfer the credit risk associated with the retention, and (b) use of the retention as collateral for secured funding, provided again that credit risk is not transferred as a result.[27] The second of these in particular appears to offer an important exemption especially in the context of the repo market. It is worth noting that the 122a Guidance expressly went on to state that the prohibition on hedging or selling the retention "does not preclude the party with the retained interest from using it for secured funding in a repo transaction," but that the Final Draft EBA Standards omit this guidance.[28] Whether this change is because the EBA has changed its mind or because it considers repo transactions are self-evidently within the ambit of secured funding is not clear. However, taking the Final Draft EBA Standards in isolation suggests that retainers engaging in repo funding should not have undue cause for concern.

Who Conducts the Due Diligence?

In addition to the retention requirement, the CRR imposes on credit institutions and investment firms the requirement that, before investing in securitisations, they are able to demonstrate that they have a comprehensive and thorough understanding of the proposed investments together with appropriate policies and procedures in place for the analysis and recording of certain specified information or characteristics relating to those investments (the so-called "DD requirement").[29]

What Due Diligence Is Required?

The level of due diligence required under this provision is substantial and applies to every level of the relevant transaction. Broadly, investors are required to show detailed understanding of:

- the five percent retention,
- the securitisation position,
- the underlying exposures,
- other comparable transactions by the sponsors or originators,
- the sponsors' or originators' due diligence process as regards the underlying exposures,
- the valuation methodology applied to the underlying exposures, and
- all material structural features of the securitisation.[30]

The Final Draft EBA Standards provide detail on how investors are expected to comply with the due diligence requirement in practice. They show the high level of detail that is expected to satisfy these requirements. For example, due diligence of the securitisation position may include its seniority, cash flow, credit ratings, historical performance of similar tranches, covenants in the underlying documents and any credit enhancement.[31] At the asset-level, due diligence may include days' arrears, default rates, prepayment rates, credit scores, concentration levels, loan to value ratios or any other metrics appropriate to the given asset class.[32]

The Final Draft EBA Standards further clarify that investors are expected to review their compliance with the due diligence requirement at least annually.[33] While certain operational aspects of compliance can be outsourced, liability for compliance cannot be delegated.[34] It is also no justification for a "lighter touch" due diligence process to show that a securitisation position is held in the investor's trading book save for certain limited exceptions in the case of an investor's correlation trading portfolio.[35]

Investors are also required to conduct regular stress testing in relation to their securitisation positions.[36] These should be conducted with a view to assessing and maintaining the appropriate amount, type and distribution of internal capital required to cover the associated risks.[37] In the case of ABCP programmes, investors may satisfy the stress-testing requirement by reference to a liquidity facility provider covering 100 percent of the credit risk of the transaction instead of the securitised exposures.[38]

REQUIREMENTS FOR INSTITUTIONS THAT ARE ORIGINATORS, SPONSORS AND ORIGINAL LENDERS

Where the originator, sponsor or original lender is a credit institution or investment firm, that entity will be subject to two separate requirements: (a) the application of sound credit granting criteria during the origination process, and (b) the disclosure of information to investors in the securitisation.

Credit Granting

Originators, sponsors and original lenders are required to "apply the same sound and well-defined criteria for credit-granting…to exposures to be securitised as they apply to exposures to be held in their own non-trading book."[39] As well as informing the origination process that should be adhered to prior to securitising a portfolio of assets, this has implications for the servicing and refinancing of securitised assets as well as the eligibility criteria that form the basis of credit-granting during the life of a securitisation. For example, a sponsor institution may not originate assets itself and may therefore not have credit-granting criteria outside the terms of the relevant securitisation. The Final Draft EBA Standards clarify that where this is the case, sponsors and originators may satisfy the obligation by reference to an objective standard, that is by ensuring the credit-granting criteria applied in the origination of the securitised exposures are "as sound and well-defined as the criteria applied to non-securitised exposures."[40]

Disclosure

Originators, sponsors or original lenders are required under the CRR to disclose their commitment to make a five percent retention. Further, originators, sponsors and original lenders are required to ensure investors have access to all materially relevant data on the securitisation's underlying exposures.[41] While there may be cases where it is appropriate for this data to be disclosed in aggregate form, for instance in the case of a large pool of highly granular assets, the general expectation is that this obligation will be satisfied on a loan-by-loan basis.[42]

WHAT HAPPENS IF THESE REQUIREMENTS ARE BREACHED?

Sanctions for Institutions When Investing in a Securitisation

Competent authorities may impose penal risk weights on investments in securitisation positions in respect of which the requirements for risk retention, due diligence or disclosure have not been satisfied in any material respect by reason of the negligence or omission of the investing credit institution or investment firm.[43]

Sanctions for Institutions When Acting as the Originator or Sponsor of a Securitisation

Where the requirements for sound credit-granting criteria have not been complied with, an originator of the relevant securitisation that is a credit institution or investment firm will not be entitled to exclude the securitised assets from the calculation of its risk-weighted assets (that is, there will not be deemed to have been a significant risk transfer), and will therefore be required to hold additional regulatory capital against the investment.[44]

In addition, penal risk weights may be applied as discussed above. If this occurs as a result of a total failure on the part of an originator or sponsor to meet the retention requirement then clearly they will hold no exposure to which the penal risk weight could be applied. However, if it arises as a result of a failure to make adequate disclosure then the retained interest (and any other interest held by the originator or sponsor) would be penalised accordingly.

CRR VERSUS ARTICLE 122A — WHAT'S DIFFERENT

The risk retention regime under Article 122a and the 122a Guidance was considered sufficiently flexible by market participants to be adaptable to the majority of European securitisation structures and asset types. By contrast, following publication of the Final Draft EBA Standards, the CRR regime has generally been considered more rigid, uncertain and less suitable to dealing with the variety and complexity of transactions to which it applies. The impact of these changes is considered below.

How Do the Level One Texts Differ?

Differences in the level 1 text of Article 122a and the applicable provisions of the CRR are minimal. The most notable changes are the introduction in the CRR of the option to retain five percent of the first loss piece of each securitised exposure and the inclusion of investment firms in the definition of "sponsor."[45]

What About the Guidance?

The more significant changes between the two regimes are contained in their associated guidance, the 122a Guidance and the Final Draft EBA Standards respectively. These include:

- the removal of retention by a so-called "aligned entity" of the originator, sponsor or original lender,
- the removal of retention on a consolidated accounting basis,
- the omission of express grandfathering provisions,
- the restriction of the availability of retention via unfunded synthetic, contingent or derivative means, and
- the introduction of new methods for retention by multiple originators or original lenders.

Removal of the "Aligned Entity" Concept

Key to the flexibility of the Article 122a regime was the acknowledgement in the 122a Guidance that there could be "certain limited circumstances in which it is simply not possible to identify any party to a transaction that fits in any of the roles of 'original lender,' 'originator,' or 'sponsor.'" In these circumstances, the 122a Guidance conceded that it would be appropriate to ensure "retention by whatever party would most appropriately fulfil this role outside of the specific constraints of these definitions," bearing in mind the legislative intent to align the interests of investors in securitisations with those involved in their establishment.[46]

Further, the 122a Guidance contemplated circumstances where a party could be identified that fitted one of the roles of original lender, originator or sponsor, but that nevertheless another entity not fitting any of those roles "whose interests are most optimally aligned with those of investors — seeks instead to fulfil the retention requirement."[47]

This flexibility has been removed from the CRR regime. Instead, the retention is expected to be fulfilled by an entity that falls within the definition of original lender, originator or sponsor. The CRR regime seeks to compensate for this loss of flexibility by permitting investment firms to fulfil the role of sponsor. The impact of this change on particular transactions is considered below.

Removal of Retention by Groups on a Consolidated Accounting Basis

The CRR permits fulfilment of the retention requirement on a consolidated group basis — *i.e.*, by parents or affiliates of the originator, sponsor or original lender — in certain limited circumstances.[48]

To benefit from this permission, the group in question must have an EU parent institution which is a credit institution, financial holding company or mixed financial holding company, the securitisation must have multiple sellers of the securitised assets and such sellers must be part of the same group for the purpose of regulatory supervision under the CRR. These conditions are stricter than those imposed under the Article 122a regime, which permitted satisfaction of the retention requirement on a consolidated group basis where the originators or original lenders were not credit institutions with the effect that entities were able to be consolidated for accounting purposes but not for EU supervisory purposes and still satisfy the retention requirement on a consolidated group basis.[49] This also meant that retention could be satisfied by non-EU members of a consolidated accounting group. The impact of this change across a range of transactions is considerable and is considered further below.

"Soft" Grandfathering: Pre-January 1, 2011

For transactions established prior to January 1, 2011, the CRR regime will only apply if new assets are introduced to the transaction after December 31, 2013.[50] For non-revolving term transactions, the exemption clearly applies. For transactions with revolving pools of assets or which contemplate reinvestment of some description, however, there is no express grandfathering in force. The Article 122a regime grandfathered transactions in which "there is substitution of one exposure with another exposure for very specific pre-defined contractual reasons pursuant to the original terms of such securitisation," or similarly where "there is repurchase of an exposure with cash…the maturity of an existing exposure is extended [or] there is a change in the size of an existing exposure due to increased utilisation of the available facility."[51] These provisions were considered sufficient to cover the "ordinary course" additions or substitutions that might arise in a number of securitisation types, such as revolving pools of assets in ABCP or master trust programmes, a repurchase or substitution of assets generally in the case of breach of representation or warranty, the restructuring of a commercial real estate loan at maturity or the variation in drawings on a pool of credit card receivables. The 122a Guidance containing these provisions is not strictly applicable to the CRR regime, however, the executive summary of the Final Draft EBA Standards states that they "will remain relevant to…assessing…how to interpret substitution of exposures for transactions before" January 1, 2011.[52] It therefore seems unlikely that addition or substitution of new exposures for specific pre-defined contractual reasons after December 31, 2013 would bring a pre-January 1, 2011 transaction within the CRR regime, though clearly the EBA has stopped short of giving definitive guidance in this respect and real comfort for investors is likely to come from a precedent of inaction from competent authorities as and when it develops.

"Soft" Grandfathering: January 1, 2011 to December 31, 2013

For transactions established on or after January 1, 2011 up to December 31, 2013, the CRR regime applies subject to "soft" grandfathering for those transactions which have continuously complied, and continue to comply, with the Article 122a regime. Specifically, while such transactions are not expressly grandfathered, when considering imposing sanctions for non-compliance with the requirements of risk retention, due diligence and disclosure, "competent authorities may consider whether compliance with [Article 122a and the 122a Guidance] was and is continuously met."[53] Notwithstanding that the EBA has stopped short of expressly grandfathering transactions established on or after January 1, 2011 up to December 31, 2013, it seems unlikely that transactions established during that time which have continuously complied, and continue to comply, with the Article 122a regime but not with the CRR regime will be treated punitively.

There is no clarity on whether, if the relevant exposures are traded after December 31, 2013, the same protection will apply in favour of incoming investors. Given the adverse effects on liquidity and the arguably inequitable effect of retrospectively sanctioning good-faith transactions, it seems reasonable that such positions should be grandfathered even if transferred post-December 31, 2013. Tellingly, the ITS refer to transactions where Article 122a compliance "was and is continuously met." The use of the present tense does not suggest any cut-off point for the grandfathering and none is expressly stated elsewhere. Similarly, the criteria for grandfathering is determined by reference to compliance by the transaction itself and not by reference to the identity of the investor from time to time, all of which may give investors some comfort. Nevertheless, absent further EBA clarification on this point, investors should be aware of the potential for punitive risk weightings to be applied to such exposures acquired after December 31, 2013, and in any case the implications for the liquidity and market-value of any such exposures regardless of the time of acquisition.

It is also worth noting that the Final Draft EBA Standards state variously that "all examples included in the CEBS guidelines should, in principal, remain available," and later, "all examples included in the CEBS guidelines will remain available."[54] Some commentators have taken this to indicate that the 122a Guidance remains informative generally. However, given the express statements in the Final Draft EBA Standards that they replace the 122a Guidance, participants should be cautious of placing any firm reliance on the historic guidance which is not expressly contemplated by the CRR regime.

Unfunded Retentions Only Available to Credit Institutions

Under the Article 122a regime, it was permissible for the retainer to meet the retention requirement via synthetic, contingent or derivative means and on an unfunded basis, for example by entering a total return swap on the most subordinated tranche or by providing a letter of credit to the securitisation.[55] This flexibility has been curtailed under the CRR regime and where used otherwise than by a credit institution (albeit not necessarily an EU credit institution) the relevant position must be fully cash collateralised and held on a segregated basis as client funds.[56]

Retention in the Case of Multiple Originators or Original Lenders

Under the Article 122a regime, where more than one originator or original lender not considered part of a consolidated group created or contributed the assets being securitised, those entities were required to satisfy the retention requirement on a *pro rata* basis or else the requirement had to be satisfied by a sponsor or other aligned entity.[57]

As discussed above, in the same scenario the CRR regime permits retention by a single originator or original lender provided that such entity has established the securitisation and either (a) is managing the securitisation, or (b) has contributed over 50 percent of the total pool of securitised assets.[58] While less flexible than the aligned entity and consolidated retention provisions under the Article 122a regime, this concession does offer scope for structuring compliant transactions that might otherwise have struggled to identify an appropriate retainer.

TRANSACTION SPECIFIC CONSIDERATIONS

Collateralised Loan Obligations ("CLOs")

CLO transactions have typically experienced difficulty in identifying an originator, sponsor or original lender able or willing to fulfil the retention requirement. Originators and original lenders of the underlying loans are rarely involved in the transaction post-closing and therefore have little incentive to retain any interest. Collateral managers who would otherwise qualify as sponsors are frequently U.S. entities and therefore outside the definition of sponsor.

Retention by an originator or original lender under the Article 122a regime would generally be satisfied by an "aligned entity." The 122a Guidance gave the example of retention by an "asset manager of a securitisation where there is ongoing management and substitution of exposures (where such asset manager is not a credit institution), or the most subordinated investor in a securitisation where such investor was also involved in structuring the transaction and selecting the exposures to be securitised (but is by definition neither the originator nor the sponsor, and nor is it the original lender)."[59] So, for example, retention in CLO transactions under the Article 122a regime was often satisfied by an aligned entity either in the form of a (typically U.S.) collateral manager or an involved subordinated investor. This is no longer explicitly permitted under the CRR regime. However, there may be ways in which this could be achieved under the CRR regime that are compliant with both the letter and spirit of the law.

Retention by a Non-Sponsor Collateral Manager

The CRR expanded the definition of "sponsor" to include investment firms, which does at least open the possibility of a non-credit institution collateral manager fulfilling the retention requirement, but such a collateral manager would need to be "MiFID regulated"[60] to satisfy the definition, again ruling out U.S. collateral managers (as well as U.S. parents of MiFID regulated collateral managers, who are ruled out as noted above).[61]

It may be possible, however, for a U.S. collateral manager to fit within the definitions of originator or original lender and fulfil the retention requirement on that basis. The relevant questions will be, firstly, whether it is an originator or original lender, and, secondly, if it is, does it qualify to fulfil the whole retention requirement as a single originator or original lender.

Firstly, is it an originator or original lender? This could be achieved (among other ways) either by the U.S. collateral manager itself or through one of its related entities. If the U.S. collateral manager acts for itself, for example it acquires a loan or loans for its own account before selling them into the CLO or is directly involved in the original loan agreements as the first lender of record, then it seems apparent the collateral manager would be an originator or original lender with respect to those loans where this is the case.[62] The second possibility is that it acts through a related entity. The CRR allows, "an entity which…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" to qualify as an originator.[63] There is no guidance in the CRR or Final Draft EBA Standards on what constitutes a related entity or what constitutes direct or indirect involvement in an original agreement. A concept of "close links" is used elsewhere in the CRR and focuses on tests of ownership and control, but does not require majority ownership.[64] Similarly, the concept of a "group of connected clients" is determined by control but also by a less prescriptive measure of interconnectedness in terms of credit risk.[65]

While these defined terms have no direct application to the question of what constitutes a related entity, they suggest that it may not be necessary to establish majority ownership or control. A limited equity investment, consolidation on an accounting basis, certain contractual relations or even a sufficiently interdependent business relationship could conceivably make one entity "related" to another. Once relatedness can be established, the collateral manager must show that, through that related entity, it is directly or indirectly involved in the original agreement that created the obligations of the debtor. So for example, a collateral manager that establishes a special purpose vehicle ("SPV") to act as original lender and is involved in negotiating the terms of the loans that are made through that SPV would seem to be directly involved in the creation of those loans through its related entity.

Alternatively, a collateral manager that establishes an SPV and is involved in agreeing the eligibility criteria that will apply to the loans made through that SPV but is not itself involved in agreeing terms with the underlying borrowers may be considered indirectly involved in the creation of those loans through its related entity. In either case, the requirement that there be a related entity and that the collateral manager be directly or indirectly involved in the creation of the loans through such entity would be satisfied and the U.S. collateral manager would constitute an originator or original lender.

The second question is whether a U.S. collateral manager is able to hold the retention as the sole originator or original lender. As discussed, where there are multiple such entities, the Final Draft EBA Standards allow for retention by a single originator or original lender provided that such entity has established the securitisation and either (a) is managing the securitisation, or (b) has contributed over 50 percent of the total pool of securitised assets. We would expect that in most cases a collateral manager would qualify as "managing the securitisation" and that accordingly it would be entitled to hold the five percent retention.[66]

Retention by a Warehouse Equity Provider

Similarly for a warehouse equity provider to be able to retain as an originator or original lender, the relevant question is first whether it qualifies for either role. Limb (b) of the definition of originator provides that an originator may be any entity which "purchases a third party's exposures for its own account and then securitises them." There is no guidance in the CRR or the Final Draft EBA Standards as to what is meant by an originator purchasing an exposure for its "own account." That the phrase is used at all, however, suggests there must be some degree of ownership or that the originator would need to bear the economic risk of the asset and that it would need to do so for more than a purely theoretical period of time before it was securitised. In our example, although the entity contracting to acquire and securitise loans during the warehouse period may be the warehouse entity, the economic risk of the loans will be held by the warehouse equity provider. It is arguable therefore that such an entity could fairly be considered to be purchasing exposures for its own account before securitising them and thereby qualify as an originator.

These potential solutions are subject to uncertainties, but we expect that market practice and EBA Q&A responses are likely to clarify these issues further over time.[67]

CMBS

The CRR permits "retention of a first loss exposure not less than [five percent] of every securitised exposure in the securitisation." This was not available under the Article 122a regime, and while it is unlikely for practical reasons to be widely adopted in the case of transactions securitising a large number of underlying exposures or which are contributed to by a large number of original lenders or originators, it is likely to be of use in CMBS transactions, which tend to securitise a smaller number of, or single, exposures.

In the previous iteration of the Final Draft EBA Standards, this retention option was illustrated by way of an example relevant to the securitisation of commercial real estate loans:

> The retention of B loans in the case of securitisations of the A parts of A/B loans would be considered to be an example of the application of retention option (e)…as long as the retainer retains a first loss exposure in the form of B loans of not less than [five percent][68]

There have been concerns raised as to the significance of timing in using this retention option — specifically whether splitting a loan into an A loan and a B loan as part of a transaction that is commercially distinct from a subsequent securitisation, or even merely separated by a significant time delay, would prevent the B loan from constituting a "securitised exposure in the transaction" and therefore prevent it from being relevant to, and constituting a retained portion of, the securitisation. While the above wording has not survived in the Final Draft EBA Standards, they indicate the type of application the EBA considered this retention option might have and there is nothing in the CRR that expressly rules out the application of retention option (e) in such circumstances.[69]

Nevertheless, it may be possible to achieve the same result — *i.e.*, retention via an A/B loan structure — by using retention option (d), retention of the first loss tranche. The Final Draft EBA Standards state that this option "may also be fulfilled through overcollateralisation if the originator, sponsor or original lender chooses to overcollateralise the tranches of a securitisation and such overcollateralisation acts as a 'first loss' retention."[70] In an A/B loan structure, where the B loan is always subordinated to the A loan, the A loan will always be overcollateralised to the extent of the B loan, enjoying as it does recourse to the full collateral available to the previously unsplit loan in priority to the B loan. It follows that a pool of securitised assets comprising the A loan portions of A/B loans will itself also be overcollateralised to the extent of the B loan portions not sold into the securitisation. This option has the benefit of avoiding any uncertainty regarding the significance of timing of the A/B loan split as the overcollateralisation will exist for the lifetime of the relevant loans.

Portfolio Acquisitions

The financing of acquisitions, whether of loan portfolios, businesses or other assets, by SPVs does not on the face of it give rise to any unique issues under the CRR regime.

Applying the CRR definition of securitisation (*i.e.,* "any transaction or scheme whereby the credit risk associated with an exposure or pool of exposures is tranched") suggests the relevant question is whether the SPV is funded by tranched credit risk (the requirement for association with a pool of exposures is clearly satisfied). A single loan or tranche of notes may not bring the acquisition within the CRR regime, and even a dual tranche or senior/subordinated loan structure may be out of scope provided the junior position can be properly characterised as equity. Whether structural subordination of mezzanine or non-equity subordinated debt would bring a portfolio acquisition within the CRR regime is not certain, however as noted above, the definition of "tranche" suggests that non-contractual subordination may be out of scope.

Multijurisdictional Trade Receivables Transactions

The securitisation of trade receivables is increasingly a multijurisdictional discipline. Corporates often contribute receivables from multiple jurisdictions to achieve the economies of scale necessary for a capital markets transaction and the transactions are increasingly syndicated as corporate treasurers see them as an important tool in maintaining core banking relationships.

Under the Article 122a regime, the retention requirement would frequently be satisfied by the provision of credit enhancement, if not by a seller, then by one of its affiliates or parent entities which may not have fallen within the strict definitions of originator, sponsor or original lender (for example, in the form of a subordinated loan). The flexibility offered by the 122a Guidance meant that such affiliate or parent could be consolidated on an accounting basis only and still satisfy the retention requirement.[71] This flexibility has been removed from the CRR regime.

Given the trend towards multi-seller, multijurisdictional trade receivables transactions, this may cause difficulties in the case of certain corporate originators or original lenders in jurisdictions where true sale requirements preclude the seller from providing credit enhancement or who do not satisfy the requirements for retention on a consolidated supervisory group basis or who have a non-EU parent.

Trade receivables transactions invariably involve an originator or one of its affiliates acting as the servicer. At the same time, the sellers will typically have been directly involved in creating the securitised assets rather than have acquired them on the secondary market. For such transactions, one potential solution may be for retention to be held by the servicer of the securitised assets in the capacity of sole originator.

Is a servicer which is also an affiliate of the original contracting party an originator? In this case we are concerned with limb (a) of the definition, "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." Even if they are not part of the same group for supervisory purposes, a servicer that is part of the same accounting group as the original contracting party would have a strong argument that it is a related entity and therefore qualifies as an originator. This argument might be strengthened if the servicer itself has indirect involvement in the creation of the exposures, for example by taking primary responsibility for their negotiation across the group.

Then, can the servicer hold the retention as sole originator? Again, as discussed, this means the entity has established the securitisation and either (a) is managing the securitisation, or (b) has contributed over 50 percent of the total pool of securitised assets. The servicer will typically be involved in negotiating the structure and the transaction documents and to that extent may be said to have "established" the securitisation. At the same time, the process of servicing the trade receivables is arguably the closest of any role on the transaction to "managing" the securitisation. The receivables' eligibility for funding will be pre-determined by the transaction documents leaving the servicing process as one of the few roles to retain a degree of discretion.

On this basis, without contributing any assets, a servicer, which could be based outside of the EEA and be unconsolidated for supervisory purposes with the original contracting parties within its group, would be entitled to hold the five percent retention.

ABCP Programmes

The Final Draft EBA Standards address a number of issues specific to ABCP programmes.

In the context of ABCP programmes, the Article 122a regime permitted satisfaction of the retention requirement by the provision of a liquidity facility that fulfilled certain conditions.[72] The CRR regime has helpfully clarified that the "underlying exposures" which the liquidity facility must cover are the securitised exposures, not the underlying receivables, and thus do not include the first loss piece typically funded by a deferred purchase price or subordinated loan.[73] This should alleviate any concerns from sponsor entities that supporting liquidity facilities would need to be expanded beyond their historic scope.

Less helpfully, the CRR regime has made clear that a syndicated liquidity facility will not satisfy the retention requirement.[74] As such, an ABCP Programme that relies on a syndicated liquidity facility to satisfy retention requirements will not comply with the CRR, even if the liquidity facility commitments collectively cover 100 percent of the credit risk and each commitment would otherwise in itself have satisfied the applicable conditions.

The Final Draft EBA Standards have clarified that the stress testing required to be performed by investors in securitisation positions in the case of ABCP programmes may be conducted by reference to the creditworthiness of the liquidity facility provider, where the relevant liquidity facility covers 100 percent of the credit risk.[75]

NEXT STEPS

The Final Draft EBA Standards state that "the EBA supports efforts to harmonise the approaches to risk retention taken by different jurisdictions."[76] To date, however, neither the Article 122a regime nor the CRR regime has made any express provision for harmonisation or for mutual recognition of regimes. This is in part as it was considered out of scope of the Final Draft EBA Standards to make such provision and in part because no other jurisdiction has so far finalised its risk retention regime.[77] In the absence of such provisions, industry participants should be aware that multi-jurisdictional transactions in particular may be subject to more than one risk retention regime.

The uncertainties posed by the CRR regime and the possible solutions considered here are in all cases open to clarification via the EBA's Q&A process, which is likely to begin in earnest following final approval of the Final Draft EBA Standards later this year. Similarly, any harmonisation provisions that are proposed are likely to follow finalisation of regimes in other jurisdictions. In the meantime, transaction precedent is likely to provide some certainty as to the treatment of particular structures and may help to inform any guidance which results from the EBA's Q&A process.

NOTES

1 Paragraph 9, Section 7, Directive 2009/111/EC.

2 Article 122a of the Banking Consolidation Directive 2006/48/EC.

3 Recital 24, Directive 2009/111/EC.

4 Recital 37, Capital Requirements Regulation (Regulation (EU) No 575/2013).

5 The Guidelines to Article 122a of the Capital Requirements Directive published by the Committee of European Banking Supervisors on December 31, 2010 (the "CEBS Guidelines") and the Q&A on Guidelines to Article 122a of the Capital Requirements Directive published by the EBA on September 29, 2011.

6 EBA Final Draft Regulatory Technical Standards on retention of net economic interest and other requirements relating to exposures to transferred credit risk (Articles 405, 406, 408 and 409) of Regulation (EU) No 575/2013 and Draft Implementing Technical Standards relating to the convergence of supervisory practices with regard to the implementation of additional risk weights (Article 407) of Regulation (EU) No 575/2013, published December 17, 2013.

7 Similar regimes exist or are being introduced which apply to (a) investment funds managed by European Economic Area ("EEA") investment managers (Article 17, EU Directive 2011/61/EU), and (b) EEA insurance and reinsurance undertakings and EEA undertakings for collective investment in transferable securities (Article 135(2), EU Directive 2009/138/EC), but these are beyond the scope of this article.

[8] "Credit institution" means "an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account," Article 4(1)(1), CRR. "Investment firm" means "a person as defined in point (1) of Article 4(1) of Directive 2004/39/EC, which is subject to the requirements imposed by that Directive, excluding the following: (a) credit institutions; (b) local firms; and (c) firms which are not authorised to provide the ancillary service referred to in point (1) of Section B of Annex I to Directive 2004/39/EC, which provide only one or more of the investment services and activities listed in points 1, 2, 4 and 5 of Section A of Annex I to that Directive, and which are not permitted to hold money or securities belonging to their clients and which for that reason may not at any time place themselves in debt with those clients," Article 4(1)(2), CRR, in which context "local firm" means "a firm dealing for its own account on markets in financial futures or options or other derivatives and on cash markets for the sole purpose of hedging positions on derivatives markets, or dealing for the accounts of other members of those markets and being guaranteed by clearing members of the same markets."

[9] "Securitisation" means "a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having the following characteristics: (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme," Article 4(1)(63), CRR. *See also* recital 50, CRR.

[10] It is worth noting that the definition of a "tranche" in the CRR refers to "a contractually established segment of the credit risk associated with an exposure," suggesting that non-contractual features which determine the distribution of losses relating to a credit exposure (for example, structural subordination through the interposition of a "holdco" borrower may fall outside the scope of the CRR regime — Article 4(1)(67), CRR.

[11] Articles 405(1) and 406, CRR.

[12] Articles 408 and 409, CRR.

[13] For the purposes of the CRR, an originator means "an entity which (a) 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 (b) purchases a third party's exposures for its own account and then securitises them," Article 4(1)(13), CRR. A sponsor means "an institution other than an originator institution that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third-party entities," Article 4(1)(14), CRR. Original lender is not defined in the CRR but the preamble to the Final Draft EBA Standards states at p.8 that "the term original lender should be understood to refer

to an entity which, either itself or through related entities, directly or indirectly, originally created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised and which is not the originator."

[14] Article 4(1), RTS.
[15] Article 4(2), RTS.
[16] Article 11(1)(d), RTS.
[17] Article 6(1), RTS.
[18] Article 7, RTS.
[19] Article 8, RTS.
[20] Article 9, RTS.
[21] Article 405(1)(a)-(e), CRR.
[22] Article 10, RTS.
[23] Article 11(1)(b), RTS.
[24] Article 12, RTS.
[25] Article 405(1), CRR.
[26] Article 11(1)(d), RTS.
[27] Article 13, RTS.
[28] Paragraph 67, CEBS Guidelines.
[29] Article 406, CRR.
[30] Article 406(1)(a)-(f), CRR.
[31] Article 18(1), RTS.
[32] Article 18(2), RTS.
[33] Article 17, RTS.
[34] Article 16(2), RTS.
[35] Article 21, RTS.
[36] Article 406(1), CRR.
[37] Article 73, Directive 2013/36 EU.
[38] Article 19(3), RTS.
[39] Article 408, CRR.
[40] Article 22(2), RTS.
[41] Article 409, CRR.
[42] Article 24(2), RTS.
[43] Article 407, CRR.
[44] Article 408, CRR.
[45] Article 405(1)(e), CRR; Article 4(1)(14), CRR.
[46] Paragraph 25, CEBS Guidelines.
[47] Paragraph 26, CEBS Guidelines.
[48] Article 405(2), CRR.
[49] Paragraphs 29 and 71, CEBS Guidelines. *See also* Q&A 21 of the Q&A on the

CEBS Guidelines dated September 29, 2011.
[50] Article 404, CRR.
[51] Paragraph 134, CEBS Guidelines.
[52] P.6, Final Draft EBA Standards.
[53] Article 1(7), ITS.
[54] Q&A 6 and Q&A 8, Final Draft EBA Standards.
[55] Paragraph 45, CEBS Guidelines.
[56] Article 5(2), RTS.
[57] Paragraph 29, CEBS Guidelines.
[58] Article 4(2), RTS.
[59] Paragraph 26, CEBS Guidelines.
[60] *I.e.*, to fall within the definition of "investment firm" at Article 4(1)(2), Directive 2004/39/EC.
[61] Article 4(1)(2),(14), CRR.
[62] *See* endnote 13 and for further details on retention by a CLO collateral manager *see* "EU Risk Retention Requirement: Who can now retain in a managed CLO?," Nick Shiren and Robert Canon, *The Banking Law Journal*, March 2014.
[63] The Final Draft EBA Guidelines contain similar wording in relation to original lenders, *see* endnote 13.
[64] Article 4(1)(38), CRR.
[65] Article 4(1)(39), CRR.
[66] Note, however, there are uncertainties, including whether or how any replacement collateral manager could be argued to have "established" a programme and therefore whether replacement of the collateral manager risks compromising compliance with the CRR.
[67] The EBA has been asked to confirm whether the provider of first loss funding to a CLO warehouse can satisfy the retention requirements and is in the process of considering its response (Single Rulebook Q&A, http://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2013_265#search).
[68] Article 9, Consultation Paper on Draft Regulatory Technical Standards and Draft Implementing Technical Standards published by the EBA on May 22, 2013.
[69] *See also* p.38, Final Draft EBA Standards.
[70] Article 9(1)(b), RTS.
[71] *See* endnote 49.
[72] *I.e.*, provision by the retainer of a liquidity facility covering 100 percent of the credit risk of the underlying exposures for the duration of the obligation to retain and accompanied by appropriate disclosure, *see* Paragraph 47, CEBS Guidelines.
[73] Article 6(1)(b), RTS.
[74] Question 5, Final Draft EBA Standards.

[75] Paragraph 19(3), RTS.
[76] Summary of responses to the consultation and the EBA's analysis, Final Draft EBA Standards.
[77] P.44, Final Draft EBA Standards.