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Client Alert Commentary

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European Banking Authority Risk Retention Report – Key Guidance Still Missing

Annual report generally confirms EU risk retention rules but fails to provide guidance regarding originator special purpose entities

On 22 December 2014, the European Banking Authority (EBA) issued its report on securitisation risk retention, due diligence and disclosure. The report was issued pursuant to the requirement of Article 410(1) of the EU Capital Requirements Regulation (CRR) which mandates the EBA to report annually to the European Commission on measures taken by competent authorities to ensure compliance with Articles 405-409 of the CRR. You can access a copy of the report here.[1]

The report will be of interest to all participants in the European collateralized loan obligation (CLO) market. The report concluded that most of the provisions in the EU risk retention rules were working well and should not be modified. The report recommended adopting a "direct" regulatory approach in addition to retaining the "indirect" approach in the current rules, and recommended greater global alignment of the risk retention rules.

Market participants had also hoped that the report would provide detailed guidance on originator structures for risk retention, including guidance regarding third party financial participation in such structures — both of which are of particular focus for managed CLOs. However, the report failed to provide such guidance. Instead, as explained below, the EBA identified a current loophole in the risk retention framework, permitting some transactions to comply with the letter but not the spirit of the rules, and suggested that further work be undertaken to narrow the definition of "originator".[2]

The key conclusions in the report are summarised below:

Originators

As mentioned above, the EBA stated that the broad definition of "originator" creates a potential loophole in the risk retention framework. In particular, the EBA stated that a special purpose entity could be established with third party equity investors, solely to create an originator that meets the legal definition of "originator" and noted that such structures could comply with the letter but not the spirit of the rules.[3] The EBA cited as examples of such structures (a) originator special purpose entities (SPEs) which are established with third party equity investor funding solely for the purpose of buying a third party's exposures and the exposures are securitised "within one day"[4], and (b) originator SPEs in which the originator has an asymmetric exposure to a securitisation whereby it benefits from the upside but not the downside of the retained interest.

The EBA stated that an originator must have " real substance" and should always hold "actual economic capital on its assets for a minimum period of time". By stating the two goals separately, the EBA may be implying that "real substance" would need to be established by something more than just having some genuine economic capital at risk in a transaction.

As mentioned above, the EBA concluded that the definition of "originator" should be narrowed to avoid abuse of the risk retention rules. The EBA did not signal the scope of such a modification, something that will take several months, at least, to complete.

Direct and indirect approaches

The current European risk retention framework requires investors to satisfy themselves that the risk retention rules have been complied with and imposes regulatory capital penalties on investors' holding of assets which fail to comply (the "indirect approach") for now. This differs from the US risk retention framework which will, when implemented, require the originator or sponsor (with a direct mention of CLO) to satisfy itself that the US equivalent of the risk retention rules have been complied with (the "direct approach").

The EBA concluded that the indirect approach has a positive impact on the EU markets and recommends retaining this approach. However, the EBA also recommended implementing a "complementary" direct approach which the EBA says will create more certainty and transparency for investors.[5]

Global alignment of rules

The EBA noted significant differences between the US and the EU approaches to risk retention and recommended global alignment, noting that if the rules are not harmonized they "may drive a real wedge in the global securitisation markets" and "reduce competitiveness of the EU financial industry".

Retention methods

The EBA concluded that the five existing retention methods work well and that there is no need to include additional methods. It expressly rejected the so-called "L-shaped" risk retention method (*i.e.*, a combination of horizontal and vertical risk retention) which is a feature of the US risk retention framework.

Retention on a consolidated basis

The EBA considered whether the rule regarding retention of the net economic interest on a consolidated basis should be expanded, including to capture consolidation in accordance with the accounting framework rather than just on the basis of supervision. The EBA concluded that the scope of consolidation should be restricted to the scope of supervision only.

Exemptions

The EBA considered whether the limited exemptions from the risk retention rules should be expanded,[6] but concluded that additional exemptions were not justified.[7]

Alternative alignment mechanisms

The EBA considered whether relying on alternative mechanisms for aligning interests — other than the risk retention framework would be appropriate, but concluded that the alternative methods should not be considered as a substitute for the risk retention framework.

Disclosure, due diligence and sanctions

The EBA considered whether the disclosure and due diligence requirements in the CRR, and the sanctions for breaching the risk retention rules were sufficient. The EBA recommended making no changes to those aspects of the risk retention framework.

Conclusion

The report generally confirmed that the provisions of the EU risk retention rules were working. It recommended that the rules be changed to adopt a "direct" regulatory approach and that risk retention rules be aligned globally. However, despite raising strong concerns about the market's use of the originator definition, the report does not offer any concrete guidance regarding how that definition should be modified.

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Endnotes

[1] The EBA issued the report in support of an opinion setting out its recommendations to the European Commission. Because the content of the opinion is reproduced in the report, we do not discuss the opinion further in this alert. You can access a copy of the opinion here.

[2] The EBA actually said that the loophole identified was caused by the "abuse" of the originator definition, presumably in transactions either completed or proposed, indicating the strength of the EBA's views on this issue.

[3] By acknowledging that originator SPEs comply with the letter of the rules, the EBA appears to have clarified that affected EU investors may permissibly invest in originator transactions as currently structured. The risk to such investors would thus appear to be that, if the EU risk retention rules change without grandfathering (as has been the case with prior rule changes), investors will be unable to transfer existing transactions to other affected investors after the effective date of such changes.

[4] Given the CLO market's acceptance of a minimum two-business-day holding period for spot sales and a minimum 15-business-day holding period for forward sales, the EBA's one-day example offers no real guidance to practitioners.

[5] The EBA did not address an important additional change to the rules if a direct approach were to be adopted — namely, considering expanding the definition of "sponsor" to include sponsors regulated as advisors under AIFMD, sponsors regulated under the US Investment Advisors Act of 1940, and comparably situated entities. Without a more expansive definition, EU risk retention rules having a direct effect on sponsors, originators and original lenders would exclude those non-MiFID entities from accessing EU investors in securitization transactions as sponsors.

[6] ISOCO recommended in its paper 'Global Developments in Securitisation Regulation— IOSCO', 16 November 2012, page 48, considering exempting CLOs from risk retention requirements altogether.

[7] Notably, the EBA's recommendation to retain the existing scope of exemptions indirectly confirms that EU affected investors acting as sponsors, originators and original lenders are exempt from the risk retention retained interest requirements when acting as investors.