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ONE STEP AHEAD TOWARD THE EUROPEAN SINGLE MARKET – EBA PUBLISHES FINAL DRAFT FOR RISK RETENTION FRAMEWORK IN SECURITIZATIONS

As part of the European implementation of the revised regulatory framework set out in Regulation (EU) No 575/2013 (more commonly known as the Capital Requirements Regulation or "CRR"), the European Banking Authority ("EBA"), on December 17, 2013, published Final Draft Regulatory Technical Standards ("RTS") on the retention of net economic interest relating to securitizations and Final Draft Implementing Technical Standards ("ITS") relating to the convergence of supervisory practices when implementing additional risk weights.

Despite the significant industry feedback received by the EBA during the consultation phase, the Final Draft RTS/ITS do not divert in any substantial manner from the drafts published in May 2013. To most market participants, this does not come as a surprise: the EBA has reiterated many times that it will not, and is not authorized to, modify or supplement the plain wording of the CRR (so-called level 1 text); instead, it is mandated to ensure a level playing field within the Single Market by preventing divergent national interpretations of the risk retention rules, thereby facilitating the cross-border provision of EU financial services. However, the EBA has helpfully added some clarifications and explanations when interpreting the sometimes vague risk retention requirements, and in this respect, the Final Draft RTS/ITS can be seen as putting an end to a long-standing and sometimes frustrating discussion process with the regulatory authorities.

The EU Commission has up to three months to adopt the Final Draft RTS/ITS. Once adopted, the RTS/ITS will help to stabilize the European securitization market and enhance legal clarity for market participants, in particular for those who are on the structuring side of transactions and those who act as investors.

This *Commentary* summarizes the EBA's reaction to the industry feedback on, and highlights the key changes to, the Consultation Paper on the Draft RTS/ITS published in May 2013.

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SCOPE OF APPLICATION

Reliance on Previous Guidance. The Final Draft RTS/ITS will replace the current guidance on Article 122a CRD II (which includes the CEBS guidelines from December 2010 ("CEBS Guidelines") and the subsequent Q&A report from September 2011). However, following industry request for clarification of the treatment of existing securitization transactions, the Final Draft RTS clarify that, as of January 1, 2014 (which is the date on which the CRR has come into effect in all European Member States), the previous guidance on Article 122a CRD will continue to be of relevance for circumstances that fall outside the scope of the CRR but that will be captured by Article 122a CRD II. The Final Draft ITS address two scenarios:

1. whether or not an additional risk weight should be imposed on transactions in cases where (i) there is a material breach of the risk retention regime (Articles 405 *et seq*. of the CRR) by reason of negligence or omission by an institution and (ii) the relevant transaction closed after January 1, 2011 but before January 1, 2014; and

2. for transactions that closed prior to January 1, 2011, how to interpret the substitution of exposures anytime after that date.

Market-Making Exemption for Third Countries. The risk retention regime applies on a consolidated level and even includes entities situated outside the EU, if they are consolidated with a European institution. Following the introduction of a market-making exemption by the CEBS Guidelines, the securitization industry had requested that such market-making exemption should be retained for immaterial exposures. The EBA has followed this request by introducing an exemption from the risk retention regime for institutions on a consolidated level, where the securitization positions are (i) held by the entity that falls outside the scope of the CRR, (ii) held in the trading book of that entity for the purpose of market-making activities, and (iii) not material with respect to the overall risk profile of the consolidated group's trading book and do not form a disproportionate share of the trading activities of the group. This concession, which is now reflected in Article 3(4) of the Final Draft RTS, is based on the general principles set out in Article 14(2) of the CRR, which excludes immaterial breaches by entities that are established in a third country and included in the consolidation.

ELIGIBLE RETAINER OF RISK

Definition of Sponsor. The Final Draft RTS remove the flexibility that had been provided by the CEBS Guidelines to identify an eligible risk retainer in certain limited scenarios on the basis of a "most appropriate person concept." Without that flexibility, the sponsor definition as drafted in the CRR is generally seen to be inappropriately narrow, in particular for collateralized loan obligation ("CLO") transactions. The EBA has confirmed that the sponsor definition is limited to credit institutions and investment firms that fall under the definition of point (1) of Article 4(1) of the MiFID and satisfy all other criteria of Article 4(2) of the CRR.

This means that collateral managers that are (i) regulated under the AIFM Directive, (ii) located outside the EU, or (iii) not fully licensed investment firms (e.g., because they do not conduct custodian services or safekeeping) will not be considered eligible retainers for the purposes of the risk retention regime. This also means that transactions that have been structured after 2011 involving a collateral manager that does not comply with the requirements of the final sponsor definition will have to be modified (either by replacing the existing collateral manager with an eligible risk retainer or by having the collateral manager become a fully licensed investment firm), if compliance with the risk retention rules is sought. This will particularly affect U.S. CLO managers, as they will not qualify as eligible risk retainers. Furthermore, CLO transactions that are compliant with the U.S. risk retention regime under Dodd-Frank will require additional structural elements to become compliant with the EU risk retention regime. For the CLO industry, this is certainly not the desired outcome.

Risk Retention on a Consolidated Basis. Article 405(2) of the CRR allows risk retention on a consolidated level if exposures are being securitized from several credit institutions, investment firms, or other financial institutions that are included in the scope of supervision on a consolidated basis.

The first question that had been raised by the securitization industry was whether or not risk retention on a consolidated level would require there to be more than one entity whose exposures are to be securitized. The EBA has responded in the Final Draft RTS that in order to achieve alignment of interests of originators, sponsors, and investors, it is important that the entity retaining the net economic interest is within the scope of consolidation. So, this means that it does not matter whether there is one or multiple originators and which group entity retains the interest, as long as the risk retainer is fully consolidated for supervisory purposes.

The response given by the EBA in the Final Draft RTS has two further significant implications: risk retention is not possible where (i) the retainer is consolidated based on the applicable accounting framework but is not included in the scope of supervision on a consolidated basis and (ii) the parent institution is established outside the EU. According to the EBA, to allow risk retention on a consolidated basis in these scenarios would not be in compliance with the level 1 text of the CRR.

METHODS OF RETENTION OF INTEREST

Risk Retention on a Synthetic or Contingent Basis. Retention of interest on a synthetic or contingent basis, including by way of derivatives, had already been confirmed during the consultation phase. The Final Draft RTS add a further nuance to this: if the risk is retained on a synthetic or contingent basis by an entity other than a credit institution, the interest retained needs to be fully cash collateralized. As a practical consequence, this method of retaining risk will only be of interest for credit institutions.

Multiple Originators/Original Lenders. In response to the concern of many market participants that transactions having multiple sponsors/originators (such as asset-backed commercial paper ("ABCP") transactions) may not be able to meet the risk retention requirements (which had been catered for by the CEBS Guidelines), the Final Draft RTS now allow retention in full by one single originator or original lender, (i) if such entity has established and is managing the program or securitization scheme (i.e., performs a sponsor role) or (ii) if the originator or original lender has established the program or securitization scheme and has contributed more than 50 percent of the total securitized exposures.

The difference between the two options is obvious at first sight: whereas, in the first exemption, the originator/original lender remains involved in the transaction after closing ("and is managing") irrespective of its contribution, in the second exemption, the originator/original lender has no active involvement once the transaction closes. This seems clear and straightforward for static pools, but what if the originator/original lender satisfies the second exemption at the outset of the transaction but over time holds less than 50 percent of the total securitized exposures (e.g., because the transaction is in a ramp-up phase)? In line with the general rules, the risk retention requirements must be satisfied at the outset, which would mean that subsequent changes of the portfolio composition can be ignored, but in order to err on the side of caution, the originator/original lender should contribute more than 50 percent of the maximum investment volume at the closing of the transaction.

Where a transaction has multiple sponsors, the Final Draft RTS now contain a clarification according to which retention will be fulfilled either completely by the sponsor whose economic interest is most appropriately aligned with investors or by each sponsor *pro rata* in relation to the number of sponsors.

Examples of Retention Options Described in the CEBS Guidelines Remains Available. Because of the narrow wording of the retention options contained in Article 405(1) of the CRR and the confusion about their interpretation, market participants had previously welcomed the additional explanations and examples given in the CEBS Guidelines.[1] There was a unanimous view within the securitization industry during the consultation process that all forms of retention mentioned in the CEBS Guidelines should also be expressly mentioned in the RTS, as mentioning only some of these options could give rise to uncertainty as to the availability of the other options stated in the CEBS Guidelines.

The EBA has reacted to this request by retaining the additional examples of compliance with the risk retention rules

1 *See*, for example, paragraph 48 of the CEBS Guidelines.

set out in the Consultation Paper on the Draft RTS/ITS published in May 2013. In addition, the EBA has added vertically tranched notes as well overcollateralization as additional risk retention methods. Finally, it has made it clear in its response to the industry comments that (i) the examples listed in relation to retention options (a) and (d) are not meant to be exhaustive but constitute one of several options to comply with the risk retention requirements and (ii) inconsistent with the general statement about the application of the CEBS Guidelines (see above), all examples included in the CEBS Guidelines should, in principle, remain available. This is particularly relevant for ABCP programs, where risk retention can adopt various shapes at various levels, as well as transactions that include a first loss tranche as a means of retention. Even though the broadened interpretation of the Final Draft RTS provide for greater flexibility to comply with the risk retention requirements, in practice, market participants (and regulators) will certainly look closely at the CEBS Guidelines for gauging appropriate means to comply with the risk retention requirements.

Coverage of Senior Parts Only. In the context of fully supporting liquidity facilities in ABCP programs, the Final Draft RTS now reflect a request of a number of ABCP sponsors that the liquidity facility has to cover "only" 100 percent of the "securitized exposures" rather than the "underlying exposures." This helpful clarification ensures that the liquidity facility complies with the risk retention rules if it covers the commercial paper or other refinancing instruments issued for the acquisition of the underlying exposures, which normally have a higher nominal value than the commercial paper/refinancing instruments.

STRESS TESTS AND DISCLOSURE

With respect to ongoing stress tests to be conducted by investors and the level of disclosure by originators, sponsors, or original lenders, the Final Draft RTS contain two material changes to the Consultation Paper on the Draft RTS/ITS published in May 2013:

Stress Testing. The Final Draft RTS now clarify that in an ABCP program that is supported by a liquidity facility covering 100 percent of the credit risk (on a contingent or drawn basis) of the securitized exposures, rather than stress testing the securitized exposures, investors may test the creditworthiness of the liquidity facility provider, provided that their securitization positions are fully covered by the liquidity facility.

Disclosure of Information. Further, the EBA has clarified in the Final Draft RTS that the disclosure requirement of the retainer is limited to information the disclosure of which would not be in breach of legal or regulatory requirements or confidentiality arrangements between the institution and its customer.

GRANDFATHERING

Transactions Entered Into Between 2011 and 2014. The EBA has made it clear that exempting transactions that have been structured in good faith and in compliance with the requirements of the CEBS Guidelines and the corresponding Q&A between 2011 and 2013 from the risk retention regime would be a breach of the (at least in this respect) unambiguous wording of the CRR.

Transactions Entered Into Before 2011 with Reinvestment Capabilities After 2014. The EBA has not indicated whether transactions that were entered into prior to 2011 but provide for reinvestment options after 2014 fall within the scope of the CRR. Taking the EBA's clear statement in the preceding paragraph, such transactions would not be subject to the risk retention requirements of the CRR, but much will depend on whether and to what extent the reinvestment capability might qualify as a "new securitization" captured by the rules of the CRR.

FINAL REMARK

As indicated above, the provisions in the Final Draft RTS/ITS do not come as a surprise to most market participants. They do contain further helpful clarifications and explanations when interpreting the sometimes vague risk retention requirements. However, most importantly, the Final Draft RTS/ITS put an end to a (too) long period of uncertainty and frustration among market participants, who can now concentrate on the business and focus again on the structuring and execution of securitization transactions.

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