

More than words

A comparison of the EU risk retention rules and the latest US proposals reveals two fundamentally different approaches to regulating securitisation

With the publication in the Federal Register of a second notice of proposed rulemaking (NPR2) on September 20 2013, the US has moved a step closer to introducing a risk retention regime for securitisations. Like its equivalent in the EU, which was first introduced under article 122a (Article 122a) of Directive 2006/48/EC (CRD) on January 1 2011, NPR2 would set the minimum level of risk retention at five percent. However, beyond that percentage figure, just how similar are the two sets of rules?

The existing Article 122a risk retention regime and that proposed in NPR2 represent fundamentally different approaches by lawmakers on opposite sides of the Atlantic. Article 122a operates to limit the audience of permitted purchasers when its requirements are not satisfied. It means that a non-compliant securitisation may still be completed, provided that it is sold only to investors which are not subject to those requirements. Under the contemplated US regime, compliance with the risk retention requirements, once they become effective, is (absent an exemption) not optional. Failure to comply would be a violation of the US Securities Exchange Act of 1934 and could lead to enforcement action.

Which transactions are caught?

You say “securitization”, I say “securitisation”. But it’s not spelling that distinguishes the scope of the two regimes. Article 122a applies to a ‘securitisation’, defined in the CRD as:

‘a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranching, having the following characteristics:

- 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.’

As a result, for a transaction to be a securitisation for the purposes of Article 122a:

- it does not need to involve an issue of securities. So, for example, an SPV holding self-liquidating financial assets

and financed by bank lending could fall within the scope, as could a transaction where the exposure to a collection of self-liquidating financial assets is tranching using a credit derivative; and,

- it needs to involve some form of tranching financing. So, for example, an SPV financed solely by a single tranche of securities would not be a securitisation for these purposes.

By contrast, NPR2 applies to a ‘securitization transaction’. This is defined as ‘a transaction involving the offer and sale of asset-backed securities by an issuing entity’, with ‘asset-backed securities’ defined as ‘a fixed-income or other security collateralised by any type of self-liquidating financial asset... that allows the holder of the security to receive payments that depend primarily on cash flow from the asset...’. Therefore, unlike Article 122a:

- transactions that do not involve an issue of asset-backed securities will not fall within the ambit of NPR2 (for example, per the discussion in NPR2, synthetic securitisations are out of scope); and,
- there is no need for any element of credit risk tranching. So an SPV financed by a single tranche of asset-backed securities could be in-scope for NPR2.

Are all transactions treated in the same way?

Article 122a provides a single set of risk retention rules for all securitisations. However, NPR2 introduces a standard approach to satisfying the risk retention requirements (standard approach), which is available to all securitisation transactions, plus a series of alternative rules which securitisation transactions of certain specified asset classes may comply with instead (asset-specific approaches). The most relevant of these asset-specific approaches include those aimed at open market collateralised loan obligations (CLOs), revolving master trusts, commercial mortgage-backed securities (CMBS) and asset-backed commercial paper (ABCP) conduits. It should be noted, however, that the structures typically used in many EU jurisdictions for mortgage master trusts, ABCP conduits, arbitrage CLOs, and CMBS transactions may struggle to fall within the specific provisions included in

NPR2 for those types of transactions, which have clearly been drafted with a very narrow set of US deal structures in mind.

Who must comply?

The risk retention regime under Article 122a applies to ‘credit institutions’ (for example, deposit-taking banks and building societies) which are prudentially-regulated in the EU and which invest in (or otherwise assume an exposure to) a securitisation. From July 22 2013, similar rules have been introduced in the EU under article 17 of Directive 2011/61/EU (Article 17) for managers that invest in securitisations on behalf of an ‘alternative investment fund’ (which includes most types of hedge fund, private equity fund, and so on). Article 17 requirements apply to EU fund managers, and managers elsewhere which manage EU funds or market funds in the EU.

From January 1 2014, Regulation (EU) No 575/2013 (CRR) is set to replace the CRD. Although the provisions of Article 122a will be replicated largely without change, as articles 404 to 410 of the CRR, their scope will be extended to certain EU investment firms. Finally, there are similar risk retention requirements in the pipeline for insurance and reinsurance undertakings and Undertakings for Collective Investment in Transferable Securities (UCITS) which are a type of fund subject to additional EU regulatory requirements. Therefore, the EU’s risk retention rules bite on those investing in (or otherwise assuming an exposure to) a securitisation.

In contrast, NPR2 imposes obligations on the ‘sponsor’ of a securitisation transaction, which is defined as a ‘person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity’. It means the risk retention requirements in the US bite on the entity putting the securitisation transaction together, regardless of where that entity is located (although there is a limited exemption for certain foreign securitisations).

Who can hold the retained interest?

For a securitisation to be compliant with Article 122a, the ‘originator, sponsor or original lender’ must explicitly disclose that it will retain, on an ongoing basis, a material net economic interest in that securitisation which shall not be less than five percent. ‘Original lender’ is not defined in the CRD, so it is generally given its ordinary meaning. Under the CRD, ‘sponsor’ is limited to a credit institution that establishes and manages an ABCP programme or other securitisation

scheme that purchases assets from third party entities. Although under the CRR, this definition will be widened from credit institutions to also include certain EU investment firms. The term ‘originator’ captures both an entity which, either itself or through related entities, was involved in the original agreement that created the assets being securitised, and an entity that purchases a third party’s assets and then securitises them.

In practice, in the context of most plain vanilla securitisations, identifying the party required to fulfil the retention obligation in such a way as to make the transaction compliant with Article 122a has proven to be straightforward. In addition, where it has not been possible to identify a party to a securitisation which can be said to be an ‘originator, sponsor or original lender’ under Article 122a, a number of transactions have relied on guidelines published by the Committee of European Banking Supervisors on December 31 2010 (CEBS Guidelines). These provide that, in such circumstances, the retention undertaking may be given by ‘whatever party would most appropriately fulfil this role’. However, from early 2014 the CEBS Guidelines are scheduled to be replaced by regulatory technical standards expanding on the risk retention rules set out in the CRR. These new standards do not, as presently drafted, include the same flexibility in this regard. This could prove particularly problematic for those CLO transactions where no party willing and able to satisfy the retention undertaking can be said to be an ‘originator, sponsor or original lender’.

Under NPR2, the sponsor of the securitisation transaction is generally responsible for satisfying the risk retention requirements, although in limited circumstances another party may do so. For example, there are special provisions for certain open-market CLO transactions (where the lead arranger of the underlying loans may retain the interest) and for certain CMBS transactions (where it may be retained by a third-party purchaser). Although these options would appear to provide a fair amount of flexibility, they are actually quite narrow, and so their practical utility is severely limited. For example, the open-market CLO

exemption is unlikely to be useable for most CLOs. Similarly, the ABCP conduit exemption is too narrow to pick-up multi-level structures that clearly should not be subject to multiple levels of risk retention, but which do not fit squarely within the ABCP conduit bucket.

Retention by multiple originators or sponsors

Where there is more than one originator, the EU risk retention regime generally requires each to satisfy the retention requirement on a pro rata basis.

However, under NPR2, if there are multiple sponsors, each sponsor is responsible for ensuring that at least one of them complies with the risk retention requirements. They do not, however, all need to comply. In some cases, a sponsor may allocate a portion of the required risk retention to one or more originators, provided that certain conditions are met. These include: that any retaining originator originates at least 20% of the pool and it allocates proportionally no more of the retained risk than the percentage of the pool it originated.

Composition of the retained interest

The EU regime provides for the retention requirement to be met in one of four ways (a fifth option will be added from January 1 2014, when the CRR replaces the CRD), but not in any combination of them. These are:

- a vertical slice of the tranches sold or transferred to investors;
- an originator’s interest (for revolving securitisations only);
- randomly selected assets from the pool of assets available for potential securitisation;
- a first-loss slice from the tranches otherwise sold or transferred to investors; and,
- a first-loss slice from each of the securitised assets.

NPR2 provides some of the same options, generally requiring the sponsor to hold an ‘eligible vertical interest’ (equivalent to option (i) above) or an ‘eligible horizontal residual interest’ (equivalent to option (iv)). NPR2 also permits retention via a combination of

these options, which reflects a departure from the prior notice of proposed rulemaking (NPR1) which did not permit combinations other than in a specified L-shaped form, which was very rigid. NPR1 also included a representative sample option (equivalent to option (iii) above), but this has not been included in NPR2. In addition, NPR2 contains asset-specific approaches, which introduce additional flexibility in respect of some asset classes and market participants, provided that certain conditions are satisfied.

Measuring the five percent

Although both Article 122a and NPR2 require risk retention in an amount equal to five percent, the two sets of rules set out different routes for calculating the size of the retained interest.

Under Article 122a, depending on which retention option is selected, the retained interest must equal five percent of:

- the nominal value of each of the tranches sold or transferred to the investors (for example, the initial principal amount outstanding of the asset-backed securities issued); or,
- the nominal value of the securitised assets.

In contrast, NPR2 requires, in most instances, that the five percent be measured using fair value, determined in accordance with US Generally Accepted Accounting Principles (GAAP). Not only does this differ from the EU rules, but it may prove unduly burdensome for non-US sponsors to determine, as they are likely to use their own local GAAP or International Financial Reporting Standards for accounting purposes.

Hedging prohibition

Article 122a provides that the retained interest must not be subject to any credit risk mitigation, short positions, or hedge. This prohibition lasts for so long as the securitisation is outstanding.

Although NPR2 also prohibits the retaining sponsor from selling, transferring or hedging the retained risk, these restrictions expire on the latest of: (i) the principal amount of the securitised assets having been reduced by 67% from the closing date; (ii) the principal amount of the asset-backed securities having been reduced by 67% from the closing date; and (iii) two years after the closing date.

Disclosure requirements

Both Article 122a and NPR2 include extensive disclosure requirements. These share the same objective: that securitisation investors should be provided with sufficient information to be able to make an informed investment decision. But there are some

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differences in approach. NPR2 contains disclosure requirements for sponsors, some of which are only applicable where reliance on one of the asset-specific approaches is sought. The EU risk retention rules also contain disclosure requirements for sponsors and originators, but they also impose due diligence obligations on securitisation investors which are subject to those rules. However, as disclosure and due diligence are two sides of the same coin, for a securitisation to comply with the EU risk retention regime, these due diligence requirements operate as an additional indirect disclosure obligation.

As the table below shows, the detail of the disclosure requirements in the two regimes differs somewhat.

Penalties for non-compliance

The penalties for non-compliance with the EU risk retention rules are focused on the

securitisation investor. The primary sanction for non-compliance with Article 122a is the imposition of higher regulatory capital charges in respect of the non-compliant securitisation investment. Under the Article 17 regime for alternative investment funds, sanctions have been left to local regulators to determine and could include fines, public sanctions and, in extreme cases, licence revocations. Under NPR2, a failure to comply with the risk retention requirements would be a violation of the US Securities Exchange Act of 1934 and could lead to enforcement action.

Exemptions

Article 122a provides for limited exemptions from the risk retention rules, including where the securitised assets are guaranteed by central governments, regional governments, central banks or multilateral development banks and

(subject to certain conditions) for transactions based on a clear, transparent and accessible index.

NPR2 contains exemptions for certain qualified asset classes which meet minimum underwriting criteria, such as residential mortgages and student loans. However, some of the proposed qualified asset definitions refer to US-specific criteria, which it may prove difficult, or impossible, for non-US assets to comply with. NPR2 also provides for more general exemptions, including for US government-backed securitisations and pass-through re-securitisations. NPR2 contains a limited exemption for foreign securitisations, but it is very narrow, requiring among other things, that the sponsor not be a US entity and that no more than 10% of the dollar value of the securities be sold or transferred to US persons or for their account or benefit.

Disclosure requirements

Article 122a

Prospective investors must have readily available access to all materially relevant data on the credit quality and performance of the securitised assets, cash flows, underlying collateral, and such information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and the underlying collateral.

Items which must be properly diligenced:

- (i) the retained interest;
- (ii) risk characteristics of each securitisation tranche and of the securitised assets;
- (iii) reputation and loss experience in earlier securitisations of the originators or sponsors in securitisations of the same asset class;
- (iv) disclosures made by the originators or sponsors about due diligence on the securitised assets and the underlying collateral;
- (v) methodologies and concepts on which the valuation of underlying collateral is based, and the policies adopted by the originator or sponsor to ensure the independence of the valuer; and,
- (vi) all the structural features of the securitisation that can materially impact the performance of the securitisation.

NPR2: Standardised Approach

Written disclosures, including:

- (i) the fair value of the asset-backed securities issued, and the key inputs and methodologies for determining fair value;
 - (ii) dollar amount of the asset-backed securities retained;
 - (iii) a description of the material terms of the retained interest;
 - (iv) the data or historical information used to develop the key inputs and assumptions; and,
 - (v) historical cash flow information from other securitisations in which the sponsor retained an interest.
- If retention is via an eligible vertical interest, the following must also be included:
- (vi) whether the sponsor will retain a single vertical security or a separate proportional interest in each class of security issued;
 - (vii) the fair value of the single vertical security retained;
 - (viii) details of what the sponsor would have been required to retain if it did not do so through a single vertical security; and,
 - (ix) if not retaining through a single vertical security, the percentage of each class that is required to be retained and which will actually be retained.

What about securitisations falling under both regimes?

For a securitisation falling under both regimes (for example, most securitisations sold to a combined US/European investor base) compliance with each is assessed independently of the other. If risk retained in satisfaction of one regime happens to fully meet the requirements of the other, then both would be satisfied. However, where compliance under one regime does not fully satisfy the requirements of the other, compliance with both will be required. This could be potentially problematic. For example, NPR2 allows combinations of different retention methods, while Article 122a does not.

Timing

Article 122a came into force on January 1 2011, and Article 17 on 22 July 2013, in each case in respect of new securitisations issued on or after January 1 2011 and, from December 31 2014, existing securitisations where new underlying assets are added after that date.

Consistent with the Dodd-Frank Act, the risk retention rules contemplated by NPR2 will become effective for residential mortgaged-backed securities one year from the date the final rules are published in the Federal Register, and two years from the date the final rules are published in the Federal Register for all other asset classes.

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