Bridging the Pond: Resolving conflicts between US and EU risk retention rules

MODERATOR:
Reed D. Auerbach, Partner, Morgan, Lewis & Bockius LLP

PARTICIPANTS

Bill Heskett
Managing Director, Head of ABS Banking, Cantor Fitzgerald

Paul Matthews
Partner, Morgan, Lewis & Bockius LLP

Karan Mehta
Head of Capital Markets, Marlette Funding

Francisco Paez
Head of Structured Finance Credit, MetLife Investment Management

Charles A. Sweet
Partner, Morgan, Lewis & Bockius LLP

Paul Vanderslice
CEO, Cantor Commercial Real Estate
Not pictured

With the evolution of risk retention rules, challenges abound for dealmakers who transact globally. It's a daily struggle to determine where U.S. rules and EU rules overlap, where the requirements vary and what transaction structures will be economically advantageous as well as compliant.
To discuss these issues and what lies ahead for the industry, Asset Securitization Report hosted a roundtable that included participation from brokers, attorneys and lenders. Sponsored by Morgan Lewis, what follows is an excerpted version of the conversation.

Auerbach: Charlie, can you give us an overview of the U.S. risk retention requirements?

Sweet: In broad strokes, the Dodd-Frank Act rules require 5% risk retention, either as a vertical slice of 5% of all ABS interests issued in the deal, or as a 5% GAAP fair value horizontal piece, which is basically the most subordinated piece in the capital stack. Or a combination of the two. There are special risk retention methods for some types of deals, such as CMBS, ABCP and master trusts.

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Auerbach: Paul, how does that compare to the European Union's (EU) regulations?

Matthews: The EU risk retention rules also require 5% credit risk retention, but they approach it differently from the U.S. in several respects. For example, the EU rules permit risk to be held as 5% of the nominal value of each investor tranche, which is like the U.S. vertical option, or as a first loss tranche of 5% of the nominal value of the securitized exposures, which is similar to the U.S. horizontal option but with a different valuation method, although you can't combine these methods. No value is given to excess spread under the EU rules. And there are a variety of other differences.

Sweet: And those differences can make structuring dual-complaint deals very tricky.

Auerbach: So what's new as of January 1, 2019 in the EU scheme?

Matthews: Even before then, EU-regulated investors in securitizations were required to ensure that transactions in which they invested complied with risk retention requirements as well as a number of other regulations, including due diligence and transparency requirements. Two sets of changes came into effect on the first of January 2019 – one relates to the changes to the capital treatment for banks and investment firms for securitization positions, and the other relates to due diligence requirements, risk retention and disclosure requirements for securitizations.

The regulators introduced an STS regime, which stands for "simple, transparent, and standardized" securitizations. This is a regime where the EU is trying to encourage securitizations to be as standard and straightforward as possible, by providing that transactions that comply with the STS regime can receive favorable capital treatment. However, there are numerous criteria that need to be met for a transaction to qualify for an STS designation, the first of which is that the originator, issuer and the

sponsor need to be EU entities. As a result, investing in U.S.-sponsored transactions could require EU investors to hold higher capital relative to their EU counterparts that comply with the STS regime.

The EU risk retention regime historically was imposed indirectly, by placing the onus on investors to ensure that they invested in compliant deals, versus directly on the sponsor as in the U.S. system. The EU regulations now also impose direct obligations on sponsors, originators, original lenders and issuers, with an apparently unintentional extension in some circumstances to U.S. affiliates of EU institutions. They also indirectly affect securitization market through obligations imposed on a broad group of institutional investors, which now include undertakings for the collective investment in transferable securities, or UCITS, and certain non-EU alternative investment funds. The investors are required to verify credit granting procedures, meaning the criteria and processes for extending credit to borrowers, including the assessment of the creditworthiness of individual borrowers. They're also required to verify that the required retention has been undertaken and disclosed to them. Investors are required to assess the risks of the security position, the underlying assets and the transaction structure, to develop written procedures to monitor their position going forward, to perform stress tests, to make internal reporting to management so that their risk position can be managed, and to be able to confirm to their regulator that they have a thorough and comprehensive understanding of their securitization positions. That's quite a daunting set of provisions for investors.

Sweet: So in the EU, the risk retention requirements are embedded in a broader regulatory scheme that includes other investor diligence and transparency requirements, whereas in the U.S., they're more or less a standalone regime.

"The regulators introduced an STS regime, which stands for "simple, transparent, and standardized" securitizations."

–Paul Matthews

Auerbach: Karan, your company, Marlette, is a regular issuer in the ABS markets and you've been complying with the U.S. risk retention regime. How have you done that, what obstacles have you overcome and how have you managed to finance the cost of risk retention in the U.S.?

Mehta: This has certainly been on our mind since the end of 2016. Our situation is somewhat atypical of the marketplace lending sector, not to mention the ABS market as a whole, because we sell whole loans to investors who need access to securitization. And while we stand behind our transactions and we are the issuer, we are securitizing on their behalf, on our own behalf as well as for Cross River Bank, which is the originating bank for the loans. In a sense, this represents multiple securitizations clumped together, each investor's pool is being valued individually, and therefore their slice of securities and proceeds that they're taking back is not necessarily proportional to the assets that they put in. Risk retention in that context has become a little complicated.

Our approach has been to take a vertical slice, as opposed to horizontal. We have three different majority-owned affiliates and in the securitizations we have done, the required risk retention sits in one of those three affiliates. And so those affiliates are now collateralized by multiple different assets, and each affiliate has a loan, which enables us to finance a significant portion of its risk retention holdings.

Auerbach: When you're allocating the required risk retention internally via your majority-owned affiliate structure, you're not looking at the face value of the loans in the pool, you're looking at what's believed to be the market value of those loans. Is that correct?

Mehta: Exactly. Otherwise, you've potentially got some sort of value transfer that was unintentional. For us, there's an efficiency and there's some degree of uniqueness in having majority-owned affiliates set up solely to hold and finance the risk retention interests.

Auerbach: Has the market generally adapted to the risk retention rules and how has it impacted the marketing of securities and the cost of securitization?

"Our approach has been to take a vertical slice, as opposed to horizontal."

–Karan Mehta

Vanderslice: I can speak with respect to commercial mortgage-backed security (CMBS) markets in the U.S. There is a special method of risk retention for CMBS, which allows a sponsor to transfer it's risk retention requirement to a qualified third party purchaser. What it means, as a sponsor, is you can keep a vertical slice, a horizontal slice, or an L-shaped combination. Or you can transfer a horizontal, or a horizontal piece of an L, to a third party B-piece purchaser.

It's interesting, in 2017 there were a total of 73 different U.S. CMBS deals. About 38% of those were done as horizontal, where the interests were sold off to a third-party purchaser, 36% were done as verticals, and 26% were done as Ls. In 2018, about 53% were done as horizontals., which is about 15% higher than 2017. Only 22% were done as verticals, and that's down almost 50% from 2017. And about 26% were done as Ls, which is pretty much flat to last year.

The trend in the market is to sell the horizontal piece to third party B-piece purchasers. I bring it up because that third-party purchase option is not available under the EU rules. If you do a CMBS deal, your only option of moving forward is actually a vertical deal, which will change the market. We keep hearing that at least the direct applicability of the new EU rules to U.S. affiliates of EU entities was a mistake. If this gets fixed, which we hear could take up to six months, it will help, at least for U.S. deals that are not marketed to EU investors. They will still have to be Dodd-Frank compliant, but exempt from the EU rules. We expect in the short run for European banks to lean more toward vertical deals.

Sweet: So we've got these very complicated U.S. rules that provide a special method of risk retention, for CMBS, which basically operates as a built-in financing method for any horizontal risk retention, consistent with historical CMBS B-piece practices. And the market seems to have adapted well overall.

Heskett: For all issuer categories, there was about a 12-month period where there was a lot of handwringing and industry group analysis on risk retention. Then the market settled in on certain approaches, and unfortunately, the approaches have added extra disclosure and extra diligence costs for most issuers. As an economic matter, maybe the vast majority of larger "flow" ABS issuers were already holding at least 5% skin in the game, so it hasn't been economically off-putting to them to have to document it and stand behind it.

For small or specialty finance companies and marketplace lenders, they've been focused on acquiring the capital they need to comply with the risk retention rules – they have used a myriad of approaches and financing techniques. Additionally, I don't believe that many investors will have significant focus on the type of risk retention that's selected; they mostly will want to make sure that they're going to be investing in deals that are compliant and stay compliant.

Matthews: Regardless of whether the direct applicability of the EU rules to U.S. sponsors is narrowed or eliminated, EU investors in U.S. deals still need to make sure that the deals that they invest in are compliant with the EU rules. Which as we discussed makes things complex. L-shaped holdings, for example, aren't permitted under the EU rules. Holding risk retention in a majority-owned affiliate, the third-party B-piece investor option for CMBS, those things don't exist under the EU rules. So to the extent that you have EU investors in U.S. deals, it will be a struggle to use many existing U.S. risk retention structures.

Vanderslice: What you're saying is exactly correct. In fact, in the U.S. CMBS market, there are deals that are not EU compliant. The other complication with U.S. CMBS is there is a five-year hold requirement. Assume a transaction has an expected life of 10 years. On the third party purchase option, if you sell a horizontal B-piece to a qualified third-party purchaser, the buyer is only required to hold it for five years. At the end of five years, they can sell it to another qualified third-party purchaser that then has to hold it for another five years. If you do the deal to be EU compliant, there is none of this flexibility.

Sweet: That's another general difference between the EU and U.S. rules, the EU rules apply for the life of the deal, but the U.S. rules for most risk retention options have sunset periods. It's hard to make a deal comply with two various sets of rules that are meant to get at the same thing, but that have a lot of very technical differences.

Vanderslice: The problem is you will get many fewer European investors in U.S. CMBS deals. You sacrifice the depth of the market in exchange for not being compliant. Certainly, U.S. issuers would love to be able to sell more to European accounts.

"It's hard to make a deal comply with two various sets of rules that are meant to get at the same thing, but that have a lot of very technical differences."

–Charles A. Sweet

Auerbach: Francisco, on the buy side, when you look at a deal and it's risk-retention compliant, do you have a different view whether the risk retention is vertical, horizontal or L-shaped, or are you okay with it as long as it's compliant?

Paez: The whole idea behind risk retention was to help align incentives between issuers and investors. From an investor's standpoint, one of the things that we were hoping that risk-retention may help prevent was the severe decline in collateral quality that we saw leading into the financial crisis. From that perspective, what we try to focus on is really to what extent we are accomplishing that alignment of incentives. That said, one of the things that I shy away from and get a little bit concerned about is when a sponsor takes advantage of mechanisms that mean that it may not ultimately be holding much skin in the game – for example, selling significant equity interests in a majority-owned affiliate to third parties. That's something that's going to turn us off as investors.

Auerbach: Do you see a big difference in a vertical holding and a horizontal holding, in terms of incentive for the retention holder?

Paez: One of the concerns with horizontal holdings is that there may be diverging types of incentives between issuers and investors. If you are a vertical holder, you basically have the exact same incentives as all the investors. If you're a horizontal holder, then you may have interests that are in conflict with your investors.

"The problem is you will get many fewer European investors in U.S. CMBS deals."

–Paul Vanderslice

Auerbach: One of the EU changes that went into effect in January was an expansion of the types of investors that need to comply with the rules. Among these are the UCITS that we've been hearing a lot about. How might this change affect the marketplace?

Heskett: U.S.-based asset managers are just beginning to consider the impact of increased UCITS regulation on their offshore managed funds.

Paez: The fact that you're asking UCITS to comply with these requirements certainly adds a burden. The main question for an investor is the extent that a deal is reasonably attractive from a relative value standpoint, after considering any potential burdens. As a regulated entity ourselves, we deal with this balancing act all the time, and to the extent that those deals are attractive from a relative value perspective – including any capital or other burdens – those are deals that any investor would look at.

"The whole idea behind risk retention was to help align incentives between issuers and investors."

–Francisco Paez

On that note, one important challenge we see is the risk capital treatment of securitizations under the EU rules. That has made many securitization investments less attractive for EU-based insurance companies, pension funds, and banks. I think UCITS don't really have that issue, but some of their clients may.

Relatedly, I think that the big question is really, what is that universe of EU-compliant deals today? This will shape the demand of EU-based UCITS clients. For example, our interpretation is that non-European deals are not going to be STS eligible. From that perspective, I think that is something that's going to take away some of the potential demand that you could have from regulated investors in the EU, including UCITS clients, because the capital treatment that you're going to get for non-European deals is not going to be that attractive.

"Most of the U.S. ABS, on a volume basis, are sold to large asset managers."

–Bill Heskett

Matthews: I don't want you to hold your breath, but the European Commission has been instructed to report by 2022 on whether or not STS treatment should be expanded to cover equivalent regimes in other jurisdictions.

Auerbach: Has there been feedback as to how the application of the new EU rules to UCITS would affect the marketability of U.S. deals?

Heskett: We've started asking the question. Most of the U.S. ABS, on a volume basis, are sold to large asset managers. And they are gathering funds across the globe and then making the investment decisions out of the U.S. If they have investors that place funds with them, or parts of their asset management operation, that are UCITS, it's going to cause them at the very least a complication. More likely, a shrinkage in demand.

Auerbach: Is there an element of the new EU rules that impacts asset-level data disclosures?

Matthews: Yes, the rules require asset-level data disclosures but even for EU issuers the templates aren't finalized.

Sweet: Which in any event are different from U.S. asset-level data requirements, and even then those apply only to some public asset classes. So a U.S. sponsor might not have the systems to provide asset-level data for an

EU deal, and even if they do it may not capture all the same fields.

Auerbach: Is it too soon to tell whether the applicability of the EU rules to a broader investor base will make it more compelling for a U.S. issuer to try to be dual-compliant?

Mehta: For us, ensuring dual-compliance on a deal where just a small fraction of demand is coming from Europe on its own sounds like a pretty heavy lift financially. I've reconciled myself to the idea of potentially doing Euro-only deals. What if we take $100 million or $200 million of assets, find a way to transfer them into a Euro region, get STS compliant, line up the investors in Europe with a few large money managers, and just to do a pure Euro-focused deal that we don't market in the U.S.? We could do our U.S. deals separately.

Sweet: The question really is, what are the costs of splitting your existing deal into two deals, one for the U.S. and one for the EU? Is it more or less expensive than trying to structure a single deal to comply with all of these various sets of rules?

Paez: Right.

You have really reduced the universe of European investors for whom U.S. securitizations will be attractive due to the capital rules associated with STS until there's some sort of alignment of the compliance regime. From that perspective, you really are going to be talking about the non-bank, non-insurance, non-pension funds as the only segment of the investor world that won't be adversely affected by the capital treatment associated with non-STS securitizations. In that sense, I frankly don't know whether or not the critical mass exists to justify for the issuer the burden of going through this process. I think the jury's still out.

"One of the EU changes that went into effect in January was an expansion of the types of investors that need to comply with the rules."

–Reed D. Auerbach

Auerbach: While the scope of the EU rules and their implementation are being developed, what are we supposed to advise clients?

Matthews: There's the element of watching and waiting and complying as far as we can. Some issuers are comparing what disclosure is typically being given with what's applicable under these interim provisions, and trying to comply as far as they can with those rules pending clarity on the more extensive rules anticipated in the next 18 months or possibly longer. There are potentially significant penalties under the EU rules and so there is some degree of discomfort among market participants that are paying close attention to these requirements.

Sweet: Many U.S. issuers are deciding not to make their deals compliant with the EU risk retention rules and saying that in their offering documents. Some other issuers have stated that they intend to comply with the EU risk retention rules but not the transparency rules. It remains to be seen if EU investors will be willing to buy U.S. deals on those terms and whether there will be any effect on pricing. ■

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