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EU Risk Retention Standards Final Draft Offers Clarity

By **Merryn Craske** (June 15, 2022, 2:47 PM BST)

Merryn Craske

The final draft of the regulatory technical standards in relation to EU risk retention under the EU Securitization Regulation 2017[1] has now been published by the European Banking Authority. These standards are important, as once finalized they will provide further details of the risk retention requirements.

This article summarizes some of the key aspects of those regulatory technical standards and discusses their implications for practitioners.

Background

The EU Securitization Regulation includes requirements for securitization special purpose entities, due diligence, risk retention, transparency and credit-granting standards, and a ban on resecuritization.

The regulation also introduced criteria for a securitization to be considered simple, transparent and standardized, which can, among other things, result in lower regulatory capital requirements. It has been applicable to securitizations that are within its scope since Jan. 1, 2019.

Article 6 of the regulation sets out certain risk retention requirements and requires the originator, sponsor or original lender of a securitization to retain on an ongoing basis a material net economic interest of not less than 5%. This can be held using one of five possible methods. These are, in summary:

- The retention of not less than 5% of the nominal value of each tranche;
- In the case of revolving securitizations or securitizations of revolving exposures, the retention of an originator's interest of not less than 5% of the nominal value of each of the securitized exposures;
- The retention of randomly selected exposures, equivalent to not less than 5% of the nominal value of the securitized exposures (provided that there are at least 100 potential exposures to be securitized at origination);
- The retention of the first loss tranche; and

- The retention of a first loss exposure of not less than 5% of every securitized exposure.

In addition, under Article 5 of the regulation, certain institutional investors need to verify that the risk retention obligations have been complied with, as part of their due diligence requirements in relation to their investments in securitization positions.

The EU Risk Retention Regulatory Technical Standards

The EU Securitization Regulation requires regulatory technical standards to be prepared in order to provide more detail in relation to the risk retention requirements, known as the EU Risk Retention RTS.

Until the EU Risk Retention RTS come into force, the previous regulatory technical standards put in place under the EU Capital Requirements Regulation RTS apply to securitizations that are within the scope of the EU Securitization Regulation.

Market participants have been waiting a long time for the EU Risk Retention RTS to be finalized. A final draft of the EU Risk Retention RTS was originally published by the European Banking Authority in July 2018, but it was not adopted by the European Commission.

The EU Securitization Regulation was amended in March 2021 by a further regulation, known as the EU Securitization Regulation Amendment. This was part of the EU capital markets recovery package, which was aimed at supporting recovery from the adverse economic effects of the COVID-19 pandemic.

The amendments included changes to facilitate securitizations of nonperforming exposures, or NPEs, and the introduction of a simple, transparent and standardized framework for on balance sheet synthetic securitizations, which were viewed as positive changes.

As a result of some of these amendments, the draft EU Risk Retention RTS also had to be revised. The European Banking Authority published a consultation paper in June 2021, and this was followed by the revised final draft of the EU Risk Retention RTS in April of this year.

Multiple Originators, Original Lenders, Sponsors or Servicers

The final draft provides that the material net economic interest may not be split between different types of risk retainers, and they contain useful guidance on how the interest may be held in the event of multiple originators, original lenders, sponsors or servicers.

The retained interest can either be held by the originators, original lenders, sponsors or servicers, as applicable, between themselves in accordance with the rules, or alternatively, which in many transactions is very useful, by a single originator, original lender, sponsor or servicer, provided such entity meets the relevant conditions set out in the final draft.

The wording is similar to that in the EU Capital Requirements Regulation RTS, except for the wording in relation to servicers, which was added for the purpose of NPE securitizations.

The Sole Purpose Test

The EU Securitization Regulation does not permit an entity to be considered an originator for the purposes of the risk retention requirements where it "has been established or operates for the sole

purpose of securitizing exposures."

While market participants were already familiar with the principle that the originator holding the risk retention needs to be an entity of real substance from previous regulatory guidance, the final draft EU Risk Retention RTS are important because they set out in more detail how this sole purpose test should be assessed.

In order for the originator to be eligible to hold the risk retention, the following conditions will have to be met:

(a) the entity has a strategy and the capacity to meet payment obligations consistent with a broader business model that involves material support from capital, assets, fees or other sources of income, by virtue of which the entity does not rely on the exposures to be securitized, on any interests retained or proposed to be retained…or on any corresponding income from such exposures and interests as its sole or predominant source of revenue;

(b) the responsible decision makers have the necessary experience to enable the entity to pursue the established business strategy, as well as adequate corporate governance arrangements.[2]

This requirement will need to be considered carefully.

Synthetic and Contingent Forms of Risk Retention

As in the EU Capital Requirements Regulation RTS, the retained interest is permitted to be held in synthetic or contingent form, provided that the amount retained is equal to that required under the relevant risk retention option and is disclosed to investors.

In such circumstances, the retained interest must be fully collateralized in cash, except where it is held by certain types of entities. This exception previously applied only to credit institutions but has now been extended to insurance and reinsurance undertakings.

Methods of Risk Retention

The final draft EU Risk Retention RTS provide further details of how each method of risk retention may be applied. This is useful in interpreting the rules, and helpfully, the wording has not changed substantially from the EU Capital Requirements Regulation RTS.

NPE Securitizations

One key change made under the EU Securitization Regulation Amendment is that the servicer in an NPE securitization can now act as the risk retainer, provided that it has expertise in servicing similar exposures and well-documented and adequate servicing policies, procedures and risk management controls.

The final draft sets out how it can be established that the servicer has the requisite expertise, and requires disclosure of the relevant years of experience.

The EU Securitization Regulation Amendment also made some amendments to allow the retained interest to be calculated in NPE securitizations by reference to the net value of the securitized exposures rather than the nominal value, since the securitized exposures in an NPE securitization are likely to be

sold at a discount to their nominal value, and therefore net value is more appropriate when calculating the risk retention.

It added a provision to the effect that, where there is a nonrefundable purchase price discount, the retained interest should be in an amount not less than 5% of the sum of the net value of the securitised NPEs, and, if applicable, the nominal value of any performing securitized exposures. The final draft sets out further details of how the net value should be calculated.

Synthetic Excess Spread

The European Banking Authority has determined that an originator in a synthetic securitization can use synthetic excess spread, which is subject to capital requirements, as a form of compliance with the risk retention requirements. Consequently, the final draft allows for synthetic excess spread to be taken into account when calculating the material net economic interest, but only if the risk retention is held by way of the first loss tranche.

However, this may not be particularly useful in practice as it is not in line with how synthetic excess spread is typically held in significant risk transfer transactions.

Transfers of the Retained Interest

As in the EU Capital Requirements Regulation RTS, the retained interest may generally not be sold, and cannot be subject to any credit risk mitigation or hedging. However, it may be used as collateral for secured funding purposes, and it has been helpfully clarified that this includes funding arrangements that involve a sale or transfer, provided that exposure to the credit risk is not transferred.

There are some narrow exceptions to the prohibition on selling the retained interest, which, while limited, are welcome, as such wording was not included in the EU Capital Requirements Regulation RTS. Sales are permitted:

- In the event of insolvency of the risk retainer;
- Where the retainer is unable to continue acting as such, for legal reasons beyond its control and that of its shareholders; or
- In the case of retention on a consolidated basis under Article 14 of the final draft EU Risk Retention RTS.

Fees

The EU Securitization Regulation Amendment introduced a requirement for the risk retainer to take into account any fees that may in practice be used to reduce the effective material net economic interest. The final draft EU Risk Retention RTS include useful further detail on this requirement, and it will be important to consider these provisions carefully to ensure that any fees payable to the risk retainer fall within the scope of what is permitted.

The final draft provides that there should be no arrangements or embedded mechanisms by virtue of which the retained interest would decline faster than the interest transferred, provided that amortization over time as a result of cash flow or allocation of losses will not breach this principle.

Fees for services provided by the risk retainer can be paid on a priority basis only if such fees are arm's length and do not have the effect of reducing the retained interest faster than the transferred interest.

These conditions will not be considered to be met where the fees are guaranteed or payable upfront in advance of services being provided post closing, and where the effective material net economic interest after deducting such fees is lower than the required minimum net economic interest.

Resecuritizations

Resecuritizations are banned under Article 8 of the EU Securitization Regulation, except in extremely limited circumstances. The final draft EU Risk Retention RTS provide that for such permitted resecuritizations, risk retention is required at each level of the transaction, with some narrow exceptions.

While these provisions in the final draft are unlikely to be relevant for the vast majority of securitizations, as they will not be resecuritizations, it is worth noting that the European Banking Authority also indicated that a second level of risk retention is not required at transaction level in the case of fully supported asset-backed commercial paper programs, provided that the underlying transactions are not resecuritizations and the credit enhancement does not create a second layer of tranching at program level.

This addresses a key question that market participants have been considering for some time, although in practice there may still be situations where retention may also be required at transaction level.

Adverse Selection

The EU Securitization Regulation introduced a prohibition on adverse selection of assets, to prevent originators cherry picking assets for the securitization that have a higher risk of loss than comparable retained assets.

The final draft includes provisions setting out how to determine whether assets retained on the balance sheet are comparable to the securitized assets, and the requirements can still be met if there are no comparable assets left on the originator's balance sheet, provided that this is clearly disclosed to investors.

Next Steps

The final draft EU Risk Retention RTS will need to be endorsed by the European Commission, and will then be subject to a nonobjection period for consideration by the Council of the European Union and the European Parliament.

Following that process, and assuming all goes smoothly, the EU Risk Retention RTS will be published in the Official Journal and will come into force 20 days after publication.

U.K. Risk Retention

It is important to note that the EU Risk Retention RTS will not apply in the U.K., where there is now a separate regime in relation to securitization. The EU Securitization Regulation was onshored, i.e.,

adopted as part of U.K. law, in the form in effect as at Dec. 31, 2020, the end of the Brexit transition period. It was then amended, and as so amended, it became the U.K. Securitization Regulation.

Because the EU Securitization Regulation Amendment came into force after that date, the changes it made to the EU Securitization Regulation do not apply to the U.K. Securitization Regulation. Furthermore, since the EU Risk Retention RTS were not finalized before that date, they will also not apply in the U.K. and there will need to be separate technical standards in relation to risk retention under the U.K. Securitization Regulation.

It seems likely that those U.K. technical standards will be similar to the EU Risk Retention RTS, but not identical, meaning that the considerations for U.K. originators, original lenders and sponsors, and for U.K. investors, could be different in some cases from those that will apply where the relevant entities are in the EU. In the case of transactions with a nexus to both the EU and the U.K., both sets of rules will need to be considered.

Conclusion

Where one or more of the relevant entities involved in a securitization are established in the EU and/or in the U.K., the parties will need to consider carefully the relevant risk retention rules and/or investor due diligence requirements under the EU Securitization Regulation or the U.K. Securitization Regulation, as applicable. The final draft EU Risk Retention RTS are an important step toward finalizing the EU risk retention regime and as such, will be welcomed by market participants.

Merryn Craske is a partner at Morgan Lewis & Bockius LLP.

[1] Regulation (EU) 2017/2402, as amended.

[2] EBA Final draft regulatory technical standards.