CHANGES IN EU RISK RETENTION RULES: IMPACT ON CROSS-BORDER TRANSACTIONS

Rachpal Thind and **Matthew Cahill**, Sidley Austin LLP

The new EU capital rules for banks and investment firms set out in the fourth Capital Requirements Directive 2013/36/EU (CRD IV) and the Capital Requirements Regulation (Regulation (EU) No 575/2013) (the CRR), collectively known as the CRD IV package, come into effect on 31 December 2013 and 1 January 2014, respectively.

The recast securitisation risk retention and due diligence requirements are incorporated in the CRR and it was generally anticipated that migrating the current risk retention regime under Article 122a of the existing Capital Requirements Directive 2006/48/EC (Article 122a) to the requirements set out in the CRR would be relatively straightforward, given that the two are principally the same. However, a consultation paper issued by the European Banking Authority (the EBA) on the CRR risk retention rules has highlighted some material changes in the way the risk retention rules should be applied going forward. This article examines some of the changes being proposed, and focuses in particular on issues which may arise within the context of cross-border transactions.

BACKGROUND

The current Article 122a securitisation risk retention requirements will be replaced by Articles 404 to 410 of the CRR. As the CRR is a regulation it is directly applicable in the member states without the need for national implementation. Similarly, the existing guidelines on Article 122a published by the Committee of European Banking Supervisors (the Guidelines) on 31 December 2010, and the Q&A document subsequently published by the EBA (the Q&A) on 29 September 2011, will also be replaced by Regulatory Technical Standards (RTS) in relation to the risk retention and investor due diligence requirements; and Implementing Technical Standards (ITS) in relation to additional risk weights to be applied where the risk retention and related obligations have not been complied with.

On 22 May 2013, the EBA published its consultation paper (the Consultation Paper) on the draft RTS and ITS (the Draft Technical Standards), which are significantly different from the Guidelines and do not carry over certain key provisions from both the Guidelines and Q&A. There has been much discussion on the impact of the Draft Technical Standards, particularly within the context of the CLO market. However, the concerns are not restricted to CLOs; they extend to the broad array of financing transactions drawn under the CRR definition of a "securitisation" and will, to some extent, affect market participants worldwide, not just in the European Union.

KEY ISSUES ARISING UNDER THE CONSULTATION PAPER

Removal of aligned entity concept

Article 122a provides that no credit institution is allowed to be "exposed" to a securitisation position unless the originator, sponsor or original lender retains, on an ongoing basis, a "material net economic interest" of at least 5 per cent in the securitisation. Likewise, Article 405(1) of the CRR mandates the same requirement, but also extends it to EU investment firms regulated under the Markets in Financial Instruments Directive 2004/39/EC (MiFID). In circumstances where there is no originator, sponsor or original lender, the Guidelines acknowledge that an entity whose interests are most optimally aligned with those of investors (the aligned entity) may be the risk-retaining entity and specifically note a non-credit institution collateral manager and a subordinated investor as examples of an aligned entity. This flexibility in identifying the retaining entity has been helpful in addressing certain technical issues in respect of the definitions of originator and sponsor, but also structuring transactions in circumstances where no other party is willing – or, due to capital constraints is able – to take on the retention requirement.

However, in a move which has caused somewhat of a stir in the market, the EBA is proposing to replace the concept of an aligned entity with an extended definition of "sponsor" (which is currently limited to credit institutions) to include certain categories of MiFID regulated investment firms. Although the revised definition will catch a number of CLO managers, many will still fall outside the scope of the definition, including such MiFID asset managers due to be shortly re-authorised under the Alternative Investment Fund Mangers Directive 2011/61/EU. Importantly, within the context of cross-border transactions, this means that managers outside the EU would not be able to meet the definition of sponsor and the risk retention requirements, thereby curtailing their activities in the European market.

Consolidated risk retention

Article 122a(2) allows (as does Article 405(2) of the CRR) the retention requirement to be satisfied on the basis of holdings of a consolidated group if certain conditions are met. While the text of Article 122a(2) itself only refers to consolidated retention within the context of a group headed by an EU credit institution or financial holding company whose regulatory capital requirements are supervised on a consolidated basis, the Guidelines and Q&A allow for consolidated retention by non-banking groups where the group reports on a consolidated basis for accounting purposes.

With this flexibility, groups headquartered overseas have been able to satisfy the risk retention requirements through an originator's parent company or other consolidated group affiliates. However, the Draft Technical Standards do not carry over the corresponding provisions of the Guidelines or Q&A, and thus arguably limit consolidated retention to EU entities under regulatory capital supervision. If the Draft Technical Standards are implemented in their current form, it will mean that groups headquartered outside the EU, as well as unregulated EU financial groups will be confined to risk retention on a solo basis.

Compliance by consolidated affiliates

Both the Article 122a and CRR risk retention rules apply to any consolidated affiliate of an EU credit institution that takes credit exposures for the regulatory balance sheet of the consolidated group. This includes both regulated and unregulated consolidated affiliates (such as banks, securities firms, asset management firms, financial holding companies in the financial group) regardless of where they are situated.

This can raise significant operational difficulties if subsidiaries are located in a non-EU jurisdiction where there are different or conflicting risk retention requirements, but also put them at a competitive disadvantage to other investment banks who are not subject to Article 122a (because they are not subject to consolidation with an EU credit institution). In this regard, the Guidelines provide for some flexibility in the application of the due diligence requirements of Article 122a(4) and (5) with respect to investments or exposures to securitisations in a consolidated entity's trading book. The Guidelines also specifically contemplate EU banking groups using "limited market-making function for non- or partially compliant securitisations (eg, in their non-EU authorised entities, which do not themselves otherwise fall directly within the scope of the provisions of Article 122a)". The language therefore appears to contemplate that non-EU entities of an EU banking group may sometimes engage in market-making activities where Article 122a is not satisfied.

There is a recognition in the Draft Technical Standards of adjusted measures for compliance between exposures in the trading book and non-trading book within the context of the due diligence requirements. However, the only reference to market-making activities is found in an example in the explanatory box to Article 19 of the Draft Technical Standards. It is not clear as to what extent the explanatory boxes will be incorporated within the final form RTS, but the absence of an express acknowledgement of the market-making function in the RTS will give rise to concerns as to the permissible scope of non-compliant securitisation positions in an EU banking group's trading book.

Grandfathering of existing transactions

The Draft Technical Standards are silent as to whether existing Guideline-compliant transactions with issue dates prior to 1 January 2014 which may not be compliant with the CRR will be grandfathered. It is not clear whether the issue has been deliberately omitted from the Consultation Paper or whether grandfathering has not been addressed for less substantive reasons.

It is hoped that investors in securitisations that have been structured in good faith on the basis of the Guidelines will not be penalised should they subsequently be non-compliant under the RTS, but it is possible that a regulator may require any such investors to dispose of their investments. The current position gives rise to significant uncertainty and may subsequently have an impact on an investor's ability to onsell their positions given that potential purchasers will be on notice that the securitisation may not be compliant with the CRR.

NEXT STEPS

The consultation process is open until 22 August 2013. The EBA is required to submit the Draft Technical Standards to the European Commission by 1 January 2014, but it is not yet clear as to when the RTS will be finalised and take effect. Given the uncertainty as to whether legacy deals will be grandfathered, it raises the question as to how transactions should be structured in the period prior to the RTS taking effect.

The position is not clear. On the one hand, the Draft Technical Standards are yet to be scrutinised by the EU legislators, and thus the final form of the RTS is far from certain. It therefore would seem logical to continue to act in accordance with the Guidelines and Q&A. On the other hand, the EBA makes certain observations in the Consultation Paper as to the extent to which the proposed RTS and ITS would have an impact "on transactions that are currently being structured/ carried out", which would appear to imply an expectation that the market should be on notice to structure transactions in accordance with the Draft Technical Standards.

Either way, there is no doubt that certain structures under the current regime would not be compliant with the CRR risk retention requirements. Therefore, a conservative approach may be to continue to follow the Guidelines given that they encompass more detail, but seek compliance with the Draft Technical Standards where the two conflict.