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Report

EBA report on securitisation risk retention, due diligence and disclosure

- The EBA response to the Commission's call for advice of December 2013 related to Article 512 of Regulation No 575/2013/EU on the application and effectiveness of CRR requirements for investor, sponsor and originator institutions in relation to exposures to transferred credit risk in the light of international market developments
- The requirement of CRR Article 410(1) which mandates the EBA to report annually to the Commission on the measures taken and compliance by competent authorities with Articles 405-409 of the CRR.

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Abbreviations

ABS	Asset-Backed Securities
AIFM	Alternative Investments Fund Managers
AIFMD	Alternative Investments Fund Managers Directive
AIFMR	Alternative Investments Fund Managers Regulation
AFME	Association for Financial Markets in Europe
APRA	Australian Prudential Regulation Authority
AQR	Asset Quality Review
BoE	Bank of England
CEBS	Committee of European Banking Supervisors
CLO	Collateralised Loan Obligation
CMBS	Commercial Mortgage-Backed Securities
CRA3	Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies
CRAs	Credit Rating Agencies
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DP	Discussion Paper
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
ESMA	European Securities and Markets Authority
EU	European Union
FMRD	Financial Market Regulatory Dialogue (US Department of the Treasury)
G20	The Group of 20
GSE	Government-Sponsored Enterprises
IOSCO	International Organization of Securities Commissions
ITS	Implementing Technical Standards
LGD	Loss Given Default



MIFID	Markets in Financial Instruments Directive
MCD	Mortgage Collateral Directive
NCA	National Competent Authority
OC	Overcollateralisation
OJ	Official Journal
PCS	Prime Collateralised Securities
PD	Prospectus Directive
QM	Qualified Mortgage
QCRE	Qualified Commercial Real Estate
QRM	Qualified Residential Mortgage
R&W	Representations and Warranties
RMBS	Residential Mortgage-Backed Securities
RTS	Regulatory Technical Standards
SEC	U.S. Securities and Exchange Commission
SFI	Structured Finance Instruments
SPV	Special Purpose Vehicle
SSPE	Securitisation Special Purpose Entity



Executive summary

The efficient functioning of securitisation markets can be affected by what are known as ‘misaligned incentives’ or ‘conflicts of interest’. These terms refer to situations where certain participants in the securitisation chain have incentives to engage in behaviour which, while maximising their own benefits, is not in the interests of — and may be detrimental to — others in the securitisation chain or the broader efficient functioning of the market.

Following the statement of the G20 leaders in 2009 suggesting that securitisation sponsors or originators should retain part of the credit risk of the underlying assets to ensure a stronger alignment of the interests of the issuers of securitisations and those of the final investors, rules in relation to exposures to transferred credit risk were introduced in CRD II. On 1 January 2014, risk retention provisions specified in CRD II were replaced by Part Five of the CRR, and the RTS/ITS developed under Article 410 (2)/(3) of the CRR, and came into force in July 2014. The requirements in the CRR combined with the RTS and the ITS are the continuation of the requirements in Article 122a of CRD II and the related CEBS Guidelines.

As mandated by the CRR, the EBA has reviewed the supervisory measures taken by competent authorities to ensure compliance with securitisation retention, disclosure and due diligence requirements. As described in this report, an assessment of the evidence provided by the competent authorities regarding supervisory measures to enforce the new framework and to ensure compliance with the rules related to exposures to transferred credit risk highlighted that (at least in countries with an active securitisation market), action has been taken in most jurisdictions. The limited number of breaches reported is a positive sign in that sense. However, it is important to note that a low number of breaches can also be the result of limited resources and might raise the question of whether a sufficient level of dedicated resources and prioritisation of supervision of the rules has been allocated to this area by the competent authorities.

The EBA believes that all relevant competent authorities should adopt the necessary arrangements to have sufficient dedicated resources with specific knowledge of securitisation so as to ensure proper supervision of credit institutions and investment firms originating and investing in securitisations.

In addition, the Commission requested technical advice from the EBA on assessing the appropriateness of the rules provided for in the CRR in relation to exposures to transferred credit risk in light of international developments. The EBA would like to draw attention to the fact that part of the analysis conducted in this report is related to regulations and proposals that have only been published recently.

CRR Article 405 places the onus on the investor institutions (so-called ‘indirect’ approach) to ensure that the multiple components of the risk retention requirements are satisfied: type of retainer (originator, original lender or sponsor), forms of retention used (five possible forms), level of net economic interest retained, and assessment of the consolidated situation of the



retainer. Conversely, a 'direct' approach would put the obligations on the originator, original lender or sponsor to comply with the retention requirements.

The EBA has assessed that the current framework ('indirect approach') has a positive impact on EU markets. Therefore, the EBA recommends that this approach should be kept and recommends the implementation of a complementary direct approach aimed at creating more certainty and transparency for investors.

The originator, original lender or sponsor has the choice of five different methods of retention. The method may not be changed during the term of the transaction. These methods are well established and, according to the feedback received by stakeholders and national supervisors, seem to work well. Consequently, the EBA believes that, other than these five forms of risk retention, no other form should be considered at this time and recommends further assessment of the effectiveness of the five forms in place.

Alongside the retention requirements, other mechanisms may be used to achieve an alignment of interests. However, the EBA does not believe that any alternative mechanisms should be used as a substitute or are equivalent to the current retention rules in place regardless of the asset class or securitisation structure.

Pursuant to the CRR, the entity retaining the net economic interest needs to be within the scope of consolidation and not divested from the group during the maturity of the securitisation transaction. The EBA considered whether the scope of consolidation could be expanded (including consolidation in accordance with the accounting framework) and, as documented in this report, the EBA believes that the scope of consolidation should remain restricted to the scope of supervision only.

The CRR foresees some exemptions. Following thorough analysis and considerations, the EBA has come to the conclusion that providing further exceptions could lead to abuse of the rules and that securitisation transactions could specifically be structured to meet the possible exemptions. For this reason, the EBA does not recommend expanding the area of exemptions.

Due to the wide scope of the definition of 'originator' in Article 4(1)(13) of the CRR, securitisation transactions may be structured so as to meet the legal requirements of the regulation without following the 'spirit' of the regulation. The EBA believes that the entity claiming to be the 'originator' should always be of real substance and should always hold some actual economic capital on its assets for a minimum period of time.

The CRR imposes requirements on originators to disclose appropriate information to allow investors to conduct proper due diligence. The EBA considers the disclosure requirements to be appropriate and fit for purpose to ensure both investor protection and financial stability. In addition, the EBA believes the due diligence requirements to be sufficient and proper.

Pursuant to the CRR, if an institution does not meet either the retention, due diligence or disclosure requirements, an additional risk weight shall also be imposed. CRD IV Article 67



prescribes that Member States are to ensure that the administrative penalties and other administrative measures provided for in paragraph 2 of that article can be applied, inter alia, where an institution is exposed to the credit risk of a securitisation position without satisfying the retention requirements in CRR Article 405. The EBA considers the current sanctions in terms of additional risk weights, administrative penalties and other administrative measures to be adequate.

At an international level, the thrust of the regulations is similar (retention, disclosure, transparency etc.). However, the EBA has noted several differences as highlighted in the third section of the report. The EU regime and the foreign legislation, if not harmonised, may drive a real wedge between the global securitisation markets and may further prevent EU issuers from benefiting from the global investor base and reduce EU investors' ability to benefit from global securitisation investments, thereby reducing the competitiveness of the EU financial industry and its ability to be engaged in the global securitisation market.



Background and rationale

Background and rationale for retention rules and other related requirements in securitisation

The efficient functioning of securitisation markets can be affected by what are termed ‘misaligned incentives’ or ‘conflict of interests’. These terms refer to situations where certain participants in the securitisation chain have incentives to engage in behaviour which, while maximising their own benefits, is not in the interests of — and may be detrimental to — others in the securitisation chain or the broader efficient functioning of the market. The effects of these misalignments and conflicts, amplified by the predominant ‘originate to distribute’ business model, are generally thought to have played an important role in the crisis, thereby contributing to the loss of investor confidence in securitisation products. They are also seen as one of the barriers to the recovery of the securitisation market. The G20 leaders’ statement from the Pittsburgh Summit in September 2009 recommended that securitisation sponsors or originators retain part of the credit risk of the underlying assets to ensure a stronger alignment of the interests of the issuers of securitisations and those of the final investors. Furthermore, IOSCO, in its September 2009 report entitled ‘Unregulated Financial Markets and Products’, also recommended that consideration be given to requiring originators and/or sponsors to retain a long-term economic exposure to securitisations to align interests appropriately in the securitisation value chain. IOSCO recommended specifically that the introduction of any retention requirement needed to be tailored carefully to align interests appropriately and suggested a number of principles to assist regulators in considering retention requirement approaches for their jurisdictions.

In addition, IOSCO also recommended in its report entitled ‘Global Developments in Securitization Regulation’ of November 2012 that *‘all jurisdictions should evaluate and formulate approaches to aligning incentives of investors and securitisers in the securitisation value chain, including where appropriate, through mandating retention of risk in securitisation products’*.

While originators have traditionally retained some net economic interest in the assets underlying their securitisations on a voluntary basis, the risk retention rules, accompanied by appropriate sanctions, entrench these practices and may incentivise originators, issuers and investors to conduct quality screenings properly, improve underwriting standards and adequately monitor credit risk.

In response to the concerns raised by the crisis, governments, regulators and industry standard-setters have implemented, and are considering, a number of initiatives intended to re-establish a better functioning securitisation market.

So far, regulatory initiatives have focused on measures to reduce incentive misalignments and conflicts which distorted markets before the crisis and measures intended to support the accurate



pricing of credit risk attached to securitisation products. These measures have included the following:

- i) measures that directly address the conflicts of interest and misaligned incentives within the securitisation chain and prevent the 'originate to distribute' model;
- ii) measures that address information asymmetry within the securitisation process by increasing transparency within the securitisation structure;
- iii) measures that address inappropriate incentives created by accounting revenue recognition principles and compensation systems for securitisers or originators; and
- iv) reforms designed to enhance the oversight of credit rating agencies' governance and rating process and reduce regulatory reliance on ratings, making rating agencies more transparent and accountable.

The EU legal framework on the retention of net economic interest and other requirements relating to exposures to transferred credit risk

Part Five Titles II and III of the CRR — Regulation (EU) No 575/2013 — allows investor institutions to assume exposure to a securitisation only if the originator, sponsor or original lender has disclosed to the institution that it will retain, on an ongoing basis, a material net economic interest of no less than 5% and imposes due diligence requirements on investors. It also contains disclosure requirements for sponsor and originator institutions towards investors and obligations for sponsors and originators to ensure the application of the same sound and well-defined criteria for credit-granting with respect to exposures to be securitised and exposures to be kept in the institution's books.

The RTS on the retention of net economic interest and other requirements relating to exposures to transferred credit risk ('RTS') and the ITS relating to the convergence of supervisory practices with regard to the implementation of additional risk weights ('ITS') replace the current developed under Article 410 (2) and (3) of the CRR have replaced the former guidance on CRD II Article 122a (CEBS Guidelines and the corresponding Q&A document). The EBA published the Final Draft RTS and ITS in December 2013. These RTS and ITS were subsequently adopted by the Commission, translated into all 24 official European Union languages and published on 13 March 2014. The Council and Parliament published in the Official Journal the final RTS on 13 June and the final ITS on 5 June 2014, which then came into force 20 days after publication¹.

Since the entry into force of the CRR, the EBA has continuously engaged with the National Competent Authorities as well as the industry to facilitate implementation. Going forward, the EBA will use the EBA Q&A tool for this process.

¹ http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:JOL_2014_174_R_0



1. Annual report to the Commission on the measures taken and compliance by competent authorities

1.1 Measures taken by the competent authorities to ensure compliance with the requirements of Part Five Title II and Title III by institutions

Since the introduction of the retention rules in 2011, multiple studies and surveys were conducted by the EBA with the objective of producing the annual report for the Commission pursuant to CRD II on compliance by the competent authorities with Article 122a of the CRD II and the EBA Guidelines on CRD II Article 122a and pursuant to CRD IV on compliance by the competent authorities with Article 405-409 of the CRR and the EBA RTS and ITS.

In July 2012, one implementation study was carried out to collect information on the extent to which Article 122a of the CRDII and the CEBS Guidelines were implemented by each competent authority within a supervisory framework, and how this was done. Together with the implementation study, a compliance study was conducted to collect information on the extent to which EU firms were compliant with Article 122a of the CRD II and the CEBS Guidelines (compliance by institutions in 2011), and how they were compliant.

An additional compliance study was carried out in March 2014. Similar to the first implementation study carried out in 2012, the aim of the second compliance study was to collect information on the extent to which EU firms were compliant with Article 122a of the CRD II and the CEBS Guidelines (compliance by institutions in 2013), and how they were compliant, as well as to collect information on the measures taken by the national competent authorities (NCA) to implement the new framework.

1.1.1 Implementation and compliance study with CRD II Article 122a and its Guidelines (carried out in 2012 for compliance in 2011)

The compliance and implementation studies were conducted together by means of a questionnaire directed to EU National Competent Authorities (NCAs). In addition to collecting information on the implementation of the article, the study also collated information on the timeframe of implementation and additional measures taken by competent authorities to enhance the implementation (e.g. seminars, workshops).



The EBA received twenty-seven implementation/compliance studies by 30 June 2012 or shortly thereafter from EU NCAs. All twenty-seven respondents stated that they fully comply with Article 122a and that they used the definition of securitisation under Article 4(36) of CRD II to determine whether compliance had been achieved.

The implementation study was also designed to collect information on how instances of flexibility introduced in the Guidelines (e.g. forms of retention, hedging, and market-making activities) were being used in practice.

All twenty-seven Member States stated that they complied/intended to comply with the Guidelines on Article 122a, although only nineteen Member States had implemented the Guidelines by June 2012.

Thirteen respondents stated that they had conducted training sessions to inform supervisors about the content of the Guidelines and/or included the topic in on-site examination handbooks and/or supervisory work programs.

Eight Member States had not yet implemented the Guidelines into their national legal framework or supervisory practices. The main reason for delaying the implementation or not implementing the Guidelines was because no credit institutions in their respective jurisdiction assumed exposures to securitisation positions at all or after 2010.

In most jurisdictions with an (active) securitisation market and where credit institutions assumed exposure to securitisation positions, the Guidelines had been fully implemented by competent authorities, and credit institutions were complying well with the requirements specified in CRD II Article 122a and the Guidelines.

Two respondents each identified one credit institution as being non-compliant with the retention requirements in their relevant jurisdiction. In one case, it was related to the use of the flexibility in the Guidelines regarding limited market-making activities of groups outside the EU and in the other case it was related to a credit institution investing in a securitisation where the originator did not retain a net economic interest of at least 5%.

One respondent identified three credit institutions where the due diligence requirements were not fully compliant with the Guidelines. Two cases were related to minor issues in the documentation of due diligence and one case to the stress-testing procedures.

1.1.2 Compliance study with CRD II Article 122a and its Guidelines (carried out in 2014 for compliance in 2013) and 'enforcement study' with Article 405-409 of the CRR (March 2014)

Methodology

- The questionnaire consisted of two chapters, with the second chapter further divided into sub-categories:



- i) cases of additional risk weights imposed by competent authorities in 2013 for non-compliance with Article 122a and its Guidelines
- ii) measures taken by competent authorities to ensure compliance with CRR Article 405-410 of the CRR;
 - a) description of the supervisory measures adopted by competent authorities to ensure compliance with the requirements of Part Five Titles II and III (Articles 405-410) of the CRR;
 - b) number of non-compliant cases identified with regard to the requirements imposed by Articles 405, 407 and 408 of the CRR on institutions acting as the originator, sponsor or original lender; and
 - c) number of non-compliant cases identified with regard to the requirements imposed by Articles 405 and 406 of the CRR on institutions assuming exposures to securitisations.
- The EBA received twenty-four replies by the end of August 2014 from EU NCAs National Competent Authorities.

Main outcomes

- Eleven Member States had already fully implemented supervisory practices with a schedule of incorporation into their current national framework. Measures taken consist of off-site supervision as well as on-site supervision, together with specific training to inform supervisors about the content of the new framework.
- Twelve Member States had not yet conducted supervisory measures to ensure compliance with the new legislation. The two main reasons for delaying the implementation of supervisory practices were 1) no institutions in their respective jurisdiction assumed exposures to securitisation positions at all or 2) the CRR provision has not required any substantial change to their current national framework.
- One Member State planned to incorporate supervisory measures to ensure compliance with Articles 405-409 of the CRR in the AQR reviews and stress test exercises.
- Three cases of non-compliance with Article 122a and its Guidelines (all three were in relation to due diligence requirements) were reported from two jurisdictions in 2013. In both cases, the relevant NCA did not consider the breach as a material infringement of the requirements in accordance with Article 122a paragraph 7 of CRD II and did not impose any additional risk weights.
- No compliance study has been carried out yet for the year 2014.



1.1.3 Conclusion

Following the review of the latest study and the answers provided by the different jurisdictions to the questionnaire, and despite the limited time since the adoption of the CRR, it appears that in most jurisdictions, supervisory measures to enforce the new framework and to ensure compliance with the retention, disclosure and due diligence requirements have been taken (at least in countries with an active securitisation market). The limited number of breaches reported is a positive sign in that sense.

However, the low number of cases of non-compliance reported might also raise the question of whether a sufficient level of dedicated resources and prioritisation of supervision of the rules has been allocated to this area so far. The analysis carried out has not allowed the approach used by supervisors to assess compliance with risk retention rules to be assessed in detail.

The complexity of the securitisation product and continuous product innovation makes supervisory work relating to securitisation and the retention rules difficult, costly and time-consuming if supervised appropriately.

The EBA believes that all relevant competent authorities should adopt the necessary arrangements to have sufficient dedicated resources with specific knowledge of securitisation to ensure proper supervision of credit institutions and investment firms originating, sponsoring and investing in securitisations. Dedicated teams of specialists will also improve the convergence on supervision across Member States and ensure that there is a more level playing field.



2. Response to the Commission's call for advice of December 2013 related to Article 512 of Regulation No 575/2013/EU

2.1 Assessment of the adequacy and effectiveness of existing provisions in aligning the interests of original lenders, originators and sponsors with those of investors.

2.1.1 The parties on which obligations are imposed: 'Direct' vs. 'indirect' approach

Article 405 of the CRR imposes obligations on regulated institutions being exposed to the credit risk of a securitisation position, except when acting as an originator, a sponsor or original lender, to address risk retention requirements — the so-called 'indirect' approach. These obligations prohibit EU/EEA credit institutions/investment firms from investing in securitised instruments unless one of the relevant originating parties (i.e. the originator, sponsor or original lender) of the securitisation retains no less than 5% of the economic interest in the securitisation.

The 'indirect' approach adopted in the CRR ensures that investor institutions buy only securitisations subject to the retention requirement. This approach addresses the misalignment of incentives (in particular with the 'originate to distribute' business model used in the US) between the originator, sponsor and original lenders and investors and ensures that EU investor institutions conduct proper due diligence before investing in securitisation positions. Imposing the requirement on the investor also has the benefit of making the rules enforceable, unlike imposing a requirement on the originator (so-called 'direct' approach) which would raise legal issues when the originator/sponsor/original lender is located outside the EU/EEA or are non-regulated entities.

An additional benefit of the 'indirect' approach is that it can potentially be used as an additional tool to enhance the level of sophistication of investor institutions and 'educate' investor institutions to help them make safer investments in securitisation products.

On the other hand, the 'indirect' approach appears on some occasions to act as a disincentive to investors in Europe. Submissions to the EBA's questionnaire on securitisation risk retention², due diligence and transparency requirements from industry stakeholders suggested that the indirect

² The EBA's questionnaire on Securitisation Risk Retention was sent to market participants on 1 April 2014 followed by an informal roundtable which took place at the EBA's premises on 23 April.



regime (i.e. where the investor bears the onus of monitoring compliance) sometimes causes legal uncertainty for investors, because it is difficult for investors to ascertain whether the original lender, originator or sponsor is complying with the risk retention requirement³ on an ongoing basis.

Furthermore, the indirect approach does not require EU originators to retain any economic interest in transactions sold to non-EU investors. Indeed, the burden is on the investors which means that if the securitisation transaction does not have any EU/EEA investors, the originator, sponsor or original lender does not need to comply with the retention requirement as according to CRR Article 405.

In contrast to an 'indirect' approach, a 'direct' approach puts a direct legal obligation on the originator, original lender or sponsor to retain a meaningful exposure to credit risk. Placing the obligation directly on the originator, original lender and sponsor instead of the investors reduces the legal uncertainty of non-compliance on investors and has the potential to improve investor certainty and to encourage new investors to invest in securitisations.

Besides, it potentially imposes additional compliance costs on the originators/sponsors/original lenders, and the enforceability of the rules on non-regulated originators, original lenders and sponsors not covered by the rules or based outside the EU is questionable. In addition, EU investors could invest in deals originating from outside the EU where the retention requirement does not apply.

Table 1 below summarises the pros and the cons for the two different approaches.

Table 1: Direct vs indirect approach

Approach	Pros	Cons
Indirect	A higher level of sophistication of the (potential) investor institution investing in the securitisation	Uncertainty under the regime may discourage (potential) investor institutions (lack of reporting template to disclose the retention requirements)
	Investment behaviour of EU-regulated institutions is better disciplined (and enforceable)	Additional layers of complexity by placing the burden on an additional party, i.e. the institution investing in the securitisation
	European investor institutions cannot invest in securitisations issued in jurisdictions where there is not an equivalent risk retention framework	Does not require EU originators to retain any economic interest in transactions sold to non-EU investors

³ Investors are facing situations where assessing if the form of retention claimed to be used by the originator complies with the spirit of the requirement proves to be a difficult exercise (legal uncertainty), lack of reporting template to disclose the information.



Approach	Pros	Cons
Direct	Improves legal certainty for investor institutions	EU investor institutions can invest in securitisations without retention
		Potential additional costs for originators, original lenders and sponsors

Recommendation 1: Indirect approach with the direct approach to be used as complementary

Taking into account the positive impact of the current framework on EU markets, the EBA recommends keeping the indirect approach for now and implementing a complementary direct approach: in addition originators/sponsors/original lenders should be obliged to publicly disclosed on the detailed retention form using a standardised format to create more transparency and certainty for the investors and to thereby facilitate the investors' due diligence.

Rationale

The 'indirect' approach places the onus on the investors and consequently encourages investors to only buy securitisation exposures following proper due diligence and once they fully understand the risk they are taking on. Therefore, placing the requirement on the investors rather than on the originator has the potential of serving as an additional tool to enhance the level of sophistication of investors over time. Furthermore the 'indirect' approach has the merit of increasing the ability of NCAs to enforce risk retention provisions effectively.

On the other hand, the 'direct' approach, which places the retention requirement obligation directly on originators, sponsors and original lenders instead of the investor institutions, could, while causing potential additional costs for originators, original lenders and sponsors, reduce compliance costs and improve legal certainty for investors, thereby encouraging new securitisation investors to invest. Moreover, the EBA believes that the enforcement of disclosure requirements must be possible.

Given the approach adopted in some major jurisdictions, a move towards the direct approach could also bring some benefits in terms of cross-border consistency.

2.1.2 Permitted forms of risk retention

Under the CRR rules, retainers must hold the required interest using one holding option only; combinations of holding options are not permitted.



Under Article 405, there are five different methods of retention (as opposed to four under Article 122a of CRD II), which may not be changed during the term of the transaction⁴:

- vertical slice, i.e. retention of no less than 5% of the nominal value of each of the tranches sold or transferred to the investors;
- pari passu share; in the case of retention of revolving exposures retention of the originator's interest of no less than 5% of the nominal value of the securitised exposures;
- on balance sheet, retention of randomly selected exposures, equivalent to no less than 5% of the nominal value of the securitised exposures, provided that the number of potentially securitised exposures is no less than 100 at origination;
- first loss tranche, and — if necessary — other tranches that have the same or a more severe risk profile than those transferred or sold to investors and are not maturing any earlier, so that the retention equals in total no less than 5% of the nominal value of the securitised exposures;
- retention of a first loss exposure of no less than 5% of every securitised exposure in the securitisation.

The RTS propose further detailed clarification to comply with each of these options.

Further to the options specified above, the EBA assessed the possibility of including an 'L-shape' form of retention where retention through a combination of the vertical slice holding option and the first loss tranche holding option would be an acceptable form of retention.

The combination of horizontal and vertical risk retention may mitigate some of the costs related to the horizontal only (first loss option) or vertical only risk retention options. It provides greater flexibility if the retainer can use any combination of horizontal and vertical slice as long as the 5% requirement is met. Furthermore the 'L-shaped' option as an alternative form of retention has the potential to lower funding costs, which could be beneficial for different types of transactions that do not fit neatly into the traditional model of securitisation such as certain managed transactions.

However, providing greater choice with an additional form of retention has its drawbacks: by giving originators, original lenders and sponsors the choice of how to retain risk, their chosen 'L-shape' form of retention may not be as effective in aligning interests and mitigating risks for investors. It may also complicate the implementation of risk retention as well as investors' processes for due diligence and the ongoing measurement of compliance due to the wider choices that originators, original lenders and sponsors would enjoy. That is, providing this

⁴ Exceptions provided in the Regulation No 625/2014 Article 10(1)(d) under exceptional circumstances⁵ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0017&from=EN>. The directive aims to create a Union-wide mortgage credit market with a high level of consumer protection. It applies to both secured credit and home loans. It imposes new underwriting standards for certain assets. Member States will have to transpose its provisions into their national law by March 2016.



additional form of retention may create fewer benefits or more costs for investors than other alternatives might.

The EBA has considered the ‘L-shape’ retention method as an additional suitable retention option. However, the features of this additional option would add to the complexity of measuring the net economic interest and the increase of flexibility provided by this option might reduce the overall effectiveness of the retention requirements in terms of alignment of interests.

Recommendation 2: Forms of retentions

The EBA believes that, other than the five forms of risk retention already available, no other form should be considered at this time and recommends further assessment of the effectiveness of the five forms already in place.

Rationale

The options provided in Article 405 of the CRR are well established and, according to feedback received by stakeholders and national supervisors, seem to work well and are deemed sufficient.

The EBA stresses that greater choice with additional forms of retention may have some drawbacks: because originators, original lenders and sponsors are given a greater choice with regard to how to retain risk, their chosen form may not be as effective in aligning interests and mitigating risks for investors as the options provided for in the CRR. Furthermore, the special features of an additional “L-shape” retention option would add to the complexity of measuring the net economic interest.

2.1.3 Alternative mechanisms to achieve the alignment of interests

Other mechanisms may be used to achieve an alignment of interests and/or to counteract factors that have been identified as contributing to a possible misalignment of interests, such as information asymmetry between investors and originators (or other key parties involved in the transaction), poor asset underwriting and/or servicing standards. The available mechanisms may include certain ‘natural incentives’ and certain more formal requirements, and will vary depending on the transaction structure and the nature of the underlying assets.

There are a number of natural factors in the European securitisation market that encourage relevant market participants to effectively screen, monitor and service borrowers, thereby improving interest alignment and modifying institutions’ behaviour. In particular, the natural incentives include:

- i) client relationships — —originators that rely on their client relationships for future income and funding should have better aligned incentives irrespective of their ongoing retention;



- ii) remuneration — the desire to achieve long-term sustainable profitability (as opposed to undue focus on high short-term gains);
- iii) reputation — the desire of a firm to position itself (and to maintain that position or to improve it) in a market over the longer term; and
- iv) funding — the desire to protect ongoing funding needs for future sustainability.

Other more formal mechanisms include requirements with respect to asset underwriting standards, transaction underwriting standards, buy-side due diligence requirements and disclosure requirements. These mechanisms are reflected in the other (non retention-related) provisions included in Part Five of the CRR and in other EU measures (such as the Mortgage Credit Directive⁵, or the upcoming CRA 3 disclosure requirements) and in recent market-led initiatives which may assist by reducing contributing factors to interest misalignment as identified above.

Specifically, disclosure requirements may reduce the information asymmetry issues in securitisations by ensuring that investors can undertake their own credit risk assessment with respect to a securitisation position. While information availability has always been relatively good in the European securitisation market, a number of initiatives have been introduced in recent years which work effectively to further improve the standards in this regard. These incentives include the requirements under Part Five of the CRR for institutions acting as the originator or sponsor to disclose all ‘materially relevant data’ and certain comprehensive central bank and market-led disclosure initiatives, such as those established by the ECB and the Bank of England, and the Prime Collateralised Securities (PCS) labelling initiative.

Other mechanisms may be available in the context of certain structures to enhance the alignment of interests, such as the performance-based fee arrangements commonly used in managed CLOs. CLO managers are in general already incentivised to achieve a certain degree of alignment with the interests of the CLO noteholders through the structure of their fees. However, the structure of the CLO managers’ fees is not defined by law and CLO managers could be incentivised to add risky assets to the underlying portfolio to achieve higher returns/fees. Moreover, the effectiveness of management fees (as compared to that of retention of net economic interest) is disputed by some analysts since the rationale behind the retention of net economic interest (‘skin in the game’ rules) is to align interests between investors and sponsors, i.e. if the investors lose money then the originator/sponsor loses money as well, while if the alignment is achieved through the structure of the fees, CLO managers (i.e. the sponsor or originator) will only suffer if a profit does not materialise.

⁵ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0017&from=EN>. The directive aims to create a Union-wide mortgage credit market with a high level of consumer protection. It applies to both secured credit and home loans. It imposes new underwriting standards for certain assets. Member States will have to transpose its provisions into their national law by March 2016.



Another alternative mechanism to achieve alignment of interests could involve the disclosure of R&W⁶ concerning the assets as well as a schedule of exceptions to these representations and warranties (and justification of these exceptions). However, the IMF Report 2009 pointed out that issuers of securities ‘relied on originator representations and warranties regarding the quality of the loans and the underwriting process that turned out to be inadequate [as occasionally] the originators lacked the capital and liquidity to make good on their warranties.’⁷

The retention rules were put in place in January 2011 to address one of the major shortcomings of the securitisation process. The rules have been well established in the EU and appear to function well. They have helped to de-stigmatise the securitisation product and have helped to create a more transparent securitisation market. The EBA does not believe that any of the alternative mechanisms specified above should be used as a substitute for the current retention options in place regardless of the asset class or securitisation structure.

Recommendation 3: Alternative mechanisms to achieve the alignment of interests

The EBA believes that alternative mechanisms for aligning interests other than risk retention should not be considered as a substitute for risk retention requirements.

Rationale

While the alternative mechanisms specified above are considered helpful as a complement to risk retention requirements, the EBA does not believe that there is sufficient evidence supporting the use of these alternative mechanisms as a substitute or demonstrating that they are equivalent to the current retention options in place regardless of the asset class or securitisation structure.

2.1.4 Scope of application

(i) Application on a consolidated basis

Article 405(2) of the CRR refers to cases where the parent entity is a CRR-regulated EU parent credit institution, EU financial holding company or EU mixed financial holding company and allows for retention on a consolidated basis where either of these entities or one of their subsidiaries, as an originator or a sponsor, securitises exposures from several credit institutions, investment firms or other financial institutions which are included in the scope of supervision on a consolidated basis.

⁶ The standard R&W provide investors with assurances that the loans have been properly documented, appropriate underwriting standards and servicing practices have been complied with, and the seller knows of no borrower defaults, among other things.

⁷ IMF Global Financial Stability Report October 2009 (“IMF Report 2009”).



The provision referred to above could make it challenging for sponsors to retain on a consolidated basis, as 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 MIFID⁸ and satisfy all other criteria of Article 4(2) of the CRR. This means that collateral managers that are (i) regulated under the AIFMD⁹, (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.

However, to achieve an 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 and is not divested from the group during the maturity of the securitisation transaction. Moreover, the EBA believes that the enforcement of disclosure requirements must be possible; therefore, the retaining entity needs to be included in the scope of supervision on a consolidated basis.

It is the EBA's view that retention requirements continue to be met on the basis of the prudential consolidated situation of the EU parent credit institution, EU financial holding company or EU mixed financial holding company as specified in Article 405(2) of the CRR. This approach is consistent with the EBA's observations and findings outlined in its final report to the European Commission on the perimeter of credit institutions¹⁰ established in the Member States.

Recommendation 4: Retention on a consolidated basis

The EBA believes that it is essential that consolidation be accomplished with regard to the scope of supervision on a consolidated basis (Article 405(2) of the CRR) and believes that the scope of consolidation should not be expanded.

Rationale

The EBA believes that it must be possible to enforce disclosure requirements. Therefore, the retaining entity needs to be included in the scope of supervision on a consolidated basis. Furthermore, retention within the scope of supervision on a consolidated basis will ensure transparency on retainers and the possible use of regulatory arbitrage relating to the retention position. This approach is also consistent with the EBA's observations and findings outlined in its Final Report to the European Commission on the perimeter of credit institutions established in the EU Member States.

(ii) Exemptions

⁸ Directive 2004/39/EC

⁹ An AIFM cannot obtain dual authorisation under the AIFMD and MIFID. This is contrary to the AIFMD provisions, as clarified in the COM Q&A ([ID 1142](#) and [ID 1143](#).)

¹⁰ EBA 'Draft Final Report to the European Commission on the perimeter of credit institutions established in the Member States'. October 2014.



Articles 405(3) and 405(4) of the CRR exempt certain securitisations from the retention rules (certain correlation trading activities, deals backed by government claims etc.). In general, exemptions and/or exceptions to the retention requirement could potentially be implemented for other specific securitisation asset classes or structures.

In particular, the EBA has considered a number of scenarios and specific securitisation transactions, including managed CLOs¹¹, where the eligible retainer potentially has problems with retention for economic reasons or, following a specific event, the retainer might no longer be the party acting as an originator, sponsor or original lender or be the most appropriate party to which the interests of the investors should be aligned (for example, when a sponsor declares bankruptcy).

Unlike a typical securitisation, CLO managers are not transferring credit exposures from their balance sheets. CLO managers are managing assets to create an investment return for third-party clients, like typical portfolio managers.

The EBA acknowledges the economic differences between independently managed CLOs and balance-sheet securitisations and highlights that, since the adoption of the CRR, there is a legal possibility for CLO managers to qualify as 'sponsors' because the definition of 'sponsor' has been extended from credit institutions to include both credit institutions and investment firms.

However, even though the definition of sponsor has been extended to include investment firms, some CLO managers are still facing problems with the sponsor model as it is difficult for a CLO manager to be an investment firm as defined in the CRR. Indeed, very often CLO managers are AIFMs and therefore cannot obtain dual authorisation under the AIFMD and MIFID.

Recommendation 5: Exemptions and exceptions to Article 405 of the CRR

The EBA believes that there are sufficient ways of complying with the retention rule; therefore, the EBA does not recommend allowing for any further exemptions and/or exceptions to Article 405(3) and Article 405(4) of the CRR at this time.

However, the EBA would recommend further assessing the possibility of introducing an 'exceptional circumstances' provision whereby under certain circumstances (such as the insolvency of the retainer), the retainer could be changed during the life of a securitisation transaction to ensure that the retainer is always the most appropriate entity to whom the interests of the investors should be aligned.

Rationale

The EBA believes that providing further exceptions could lead to abuse of the rules and that

¹¹ IOSCO recommended in its paper 'Global Developments in Securitisation Regulation'— IOSCO, 16 November 2012, page 48, to consider exempting CLOs from risk retention requirements.



securitisation transactions could specifically be structured to meet the possible exemptions. Furthermore, as mentioned before, the EBA does not believe that any alternative mechanisms can be used as a substitute or are equivalent to the current retention options in place regardless of the asset class or securitisation structure.

(iii) Potential loopholes

Given the continuous change in securitisation markets and the emergence of new structures, the EBA has identified some practices that raise some concerns. Indeed, it emerges that some transactions are structured so as to meet the legal requirements of the regulation but actually do not always meet the 'spirit' of the regulation and do not align the interests of the most appropriate party to retain (originator, original lender or sponsor) with the interests of the investors.

In particular, potential loopholes have been identified caused by the abuse of the 'originator' definition as defined in Article 4(1)(13) of the CRR.

CRR definition of originator

'Originator' means an entity which:

- (a) itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or
- (b) purchases a third party's exposures for its own account and then securitises them

As a result of the wide scope of the 'originator' definition in the CRR, it is possible to establish an 'originator SSPE' with third-party equity investors solely for creating an 'originator' that meets the legal definition of the regulation and which will become the retainer in a securitisation. For example, an 'originator SSPE' is established solely for buying a third party's exposures and securitises the exposures within one day. Another example is when an 'originator SSPE' has asymmetric exposure to a securitisation and benefits from any 'upside' but not 'downside' of the retained interest (see Annex I for the possible transaction structure).

The EBA considers these types of structures as non-compliant with the 'spirit' of the retention requirements and believes that the definition of 'originator' in Article 4(1)(13) of the CRR should be reassessed and narrowed down further to ensure that industry participants do not abuse the rules.

In the opinion of the EBA, the 'originator' definition should in principle ensure that the entity claiming to be the 'originator' is of real substance and holds actual economic capital on its assets



for a minimum period of time. If necessary, the EBA could do further work on narrowing down the scope of the originator definition¹².

Recommendation 6: Potential loopholes

The EBA believes that, for the purposes of the retention requirements, the ‘originator’ definition in CRR Article 4(13) should be narrowed down and defined in further detail to reduce the potential misuse of the retention requirements via legal definition loopholes and to ensure real alignment of interests between the originator and investors.

Rationale

As a result of the wide scope of the definition of ‘originator’ in Article 4(1)(13) of the CRR, it is possible to structure securitisation transactions so as to meet the legal requirements of the regulation without following the ‘spirit’ of the regulation and which, in fact, do not always align the interests of the most appropriate party to retain (originator, original lender or sponsor) with the interests of the investors.

The EBA believes that the entity claiming to be the ‘originator’ should in principle be of real substance and should always hold some actual economic capital on its assets for a minimum period of time.

If necessary, the EBA could do further work on narrowing down the scope of the originator definition.

2.2 Assessment of the appropriateness of disclosure requirements and analysis of data templates for public and private transactions

In its call for advice, the Commission has asked the EBA to assess the appropriateness of disclosure requirements for sponsor and originator institutions in conjunction with the analysis of the ongoing initiatives promoted by either public bodies or private entities for the standardisation of data templates.

2.2.1 Adequacy of disclosure requirements (CRR Article 409 and the corresponding RTS)

¹² Restriction on the scope of the originator definition should not be decided without the conduct of an impact assessment, for example for securitisation originated by a Bridge Institution as defined in the Bank Recovery Resolution and Resolution Directive (2014/59/EU). ¹³ According to Recital 2 of the CRA 3 RTS (http://ec.europa.eu/finance/rating-agencies/docs/140930-sfis_en.pdf) such RTS shall apply to all financial instruments or other assets resulting from a securitisation transaction or scheme referred to in Article 4(61) of Regulation (EU) No 575/2013 of the European Parliament and of the Council on condition that the issuer, originator or sponsor, is established, and for that purpose has its statutory seat, in the Union (i.e. use of CRR securitisation definition for defining SFI).



The disclosure requirements are fundamental to enabling investor institutions to access the important information required to analyse risks. Under CRR Article 409, originators and sponsors are required to ensure that prospective investors have readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation exposure as well as any information necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures.

Article 23 of the RTS states that ‘materially relevant’ data on the individual underlying exposures shall, in general, be provided on a loan-by-loan basis; however, in certain instances the data provided on an aggregate basis may be sufficient. In assessing whether aggregate information is sufficient, factors to be taken into account shall include the granularity of the underlying pool as well as whether the management of the exposures in that pool is based on the pool itself or on a loan-by-loan basis. While the determination of what would constitute ‘materially relevant’ data is inherently transaction and investor-specific, certain securitisation transactions have customarily not included loan-level information because it is market practice to consider this information not to be materially relevant in the context of transactions involving highly granular asset pools (which would include, but not be limited to, securitisation transactions involving portfolios of credit card receivables or auto loans with relatively small balances).

CRR requirements are not overly prescriptive (although the desire to access central bank liquidity and investor requirements may dictate otherwise and consideration also needs to be given to the impending loan-level disclosure requirements under CRA3) but rather adopt a principle-based approach to make available to investors all the information necessary to perform due diligence. The final RTS do not refer specifically to any particular loan-level template. However, those provided for in the framework of refinancing operations with the ECB and the Bank of England can be considered to be a suitable method of meeting disclosure requirements in appropriate situations.

Furthermore, the disclosure obligation under Article 409 of the CRR is subject to any other legal or regulatory requirements applicable to the retainer (including those related to confidentiality).

The EBA believes that the disclosure requirements are sufficiently comprehensive to provide essential transparency to (potential) investor institutions.

However, concerns have been raised about potential compliance challenges and significant costs for cross-border intra-EU securitisations when comparable, but not identical, disclosure requirements are imposed by different EU competent authorities.

2.2.2 Analysis of data templates for public and private transactions and the collateral frameworks of central banks



Over the past few years, several legislative provisions and central banks have introduced disclosure requirements for ¹³SFI and attempted to improve the standardisation of forms of data disclosure, including:

- **ESMA — Article 8b of the CRA3¹⁴**. On 20 June 2013, the European Regulation known as ‘CRA3’ came into force. CRA3 not only amends the European regulatory framework for credit rating agencies (‘CRAs’), but also contains certain important obligations for issuers, originators and sponsors of SFI.
 - i) Issuers, originators and sponsors established in the EU must publish disclosure. It is sufficient for only one of the issuer, originator or sponsor to be located in the EU for an SFI to be subject to the disclosure requirements.
 - ii) These issuers, originators and sponsors will be able to designate one or more entities, which may be one or more of themselves or a third party or parties, that will publish the required information on a website to be set up by the ESMA for the life of the SFI. The ESMA must be informed of the identity of the designated entity without undue delay. The issuer, originator and sponsor remain jointly responsible for complying with the disclosure requirements despite any delegation to another entity.
 - iii) The RTS¹⁵ on information on structured finance instruments adopted on 30 September 2014 by the Commission specifies that the disclosure requirements apply to all financial instruments (...) on condition that the issuer, originator or sponsor is established, and for that purpose has its statutory seat, in the Union.
 - iv) Article 5 of the draft RTS provides that the following information relating to a SFI falling within the scope of the RTS must be publicly disclosed:
 - loan-level information
 - where applicable to the SFI, the final offering document or prospectus, asset sale agreement, servicing agreement, trust deed and other transaction documents, including a detailed description of the payment waterfall of the SFI

¹³ According to Recital 2 of the CRA 3 RTS (http://ec.europa.eu/finance/rating-agencies/docs/140930-sfis_en.pdf) such RTS shall apply to all financial instruments or other assets resulting from a securitisation transaction or scheme referred to in Article 4(61) of Regulation (EU) No 575/2013 of the European Parliament and of the Council on condition that the issuer, originator or sponsor, is established, and for that purpose has its statutory seat, in the Union (i.e. use of CRR securitisation definition for defining SFI).

¹⁴ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:146:0001:0033:EN:PDF>

¹⁵ The Regulation (EU) No 462/2013 (CRA 3 Regulation) amending the Regulation (EC) No 1060/2009 requires ESMA to draft RTS regarding the information on (1) structured finance instruments (SFI) [...]



- if there is no prospectus (as defined in the Prospectus Directive [(2003/71/EC)], a transaction summary including the deal structure, asset characteristics, cash flows, note holder voting rights, triggers in the transaction and structure diagrams
 - investor reports
- v) The disclosure templates are similar¹⁶ to the templates for loan-level reporting under the eligibility requirements of the ECB for collateral it will accept as part of its liquidity operations.
- **European Central Bank**¹⁷. The ABS loan-level initiative establishes specific loan-by-loan information requirements for ABS accepted as collateral in Eurosystem credit operations. It increases transparency and makes available to market participants more timely information on the underlying loans and their performance in a standard format. In the past, assessments of ABS have been hampered by the lack of standardised, timely and accurate information on single loan exposures. The data requirements help both investors and third-party assessment providers with their due diligence. Ultimately, greater transparency helps to restore confidence in the securitisation market.

The loan-level initiative aims to:

- i) improve transparency in ABS markets by requiring loan-by-loan information to be available and accessible to market participants on an ongoing basis. This is considered necessary to revive the ABS markets;
- ii) facilitate the risk assessment of ABS as collateral used by Eurosystem counterparties in monetary policy operations.

While the comprehensive disclosure templates of the ECB have been developed to enable securities to be eligible for the Eurosystem collateral framework, and they also promote standardisation and transparency within Europe. The application of these disclosure standards could unduly prevent non-EU originators that are not readily able to provide this information from offering their ABS to EU investors.

- **Bank of England**¹⁸. When the Bank lends in its operations, it does so against collateral of sufficient quality and quantity to protect itself from counterparty credit risk. To be eligible for the Bank's operations, the following additional eligibility requirements for ABS and covered bonds have been introduced:

¹⁶ The templates in the draft CRA3 RTS were created with the Eurosystem and BoE templates as reference

¹⁷ ECB 'ABS Loan-level Initiative' <http://www.ecb.europa.eu/paym/coll/loanlevel/html/index.en.html>

¹⁸ BoE 'Sterling Monetary Framework - Eligible Collateral'

<http://www.bankofengland.co.uk/markets/Pages/money/eligiblecollateral.aspx>



- i) Loan-level information must be made publicly available at least on a quarterly basis and within a defined period of time after the relevant bond payment date for the following assets classes: RMBS, covered bonds, CMBS, CLOs, and securitisations of auto, consumer, lease and private student loans. The format is determined by the Bank, but designed with consideration of the requirements of other authorities. The prospectus, together with the closing transaction documents (excluding legal opinions), must be made freely and publicly available. These include, but are not limited to: the asset sale agreement (and any relevant declaration of trust), servicing, administration and cash management agreements, the trust deed, security deed, agency agreement, incorporated terms or master trust framework or master definitions agreement, swap documentation and liquidity facility agreements, as applicable, as well as any other relevant underlying documentation. Transaction documentation updates must be freely and publicly available.
- ii) A transaction summary in a standardised format for any new issuance must be produced and made freely and publicly available.
- iii) Standardised monthly investor reports must be provided. These reports include information on: asset performance; a detailed cash flow allocation; a list of all triggers and their status; a list of all counterparties involved in a transaction, their role and their credit ratings; details of cash injected into the transaction by the originator/sponsor or any other support provided to the transaction including any drawings under or utilisation of any liquidity or credit support and support provided by a third party; amounts standing to the credit of guaranteed investment contract and other bank accounts; details of any swaps (e.g. rates, payments and notional) and other hedging arrangements to the transaction, including any related collateral postings; and definitions of key terms (such as delinquencies, defaults and pre-payments).
- iv) A cash flow model which can be used to replicate the behaviour of the transaction structure ('liability side') must be made freely and publicly available by or on behalf of the originator/issuer.

2.2.3 Analysis of ongoing initiatives to enhance cross-sectorial consistency on disclosure requirements

Joint Committee Task Force on Securitisation. Over the past few years, different European regulations and initiatives relating to securitisation, including disclosure requirements and reporting requirements for SFI and due diligence requirements for investors have been introduced by several legislative provisions. A task force has been established under the umbrella of the Joint Committee to:



- identify any inconsistencies within the existing level-1 and level-2 due diligence and disclosure requirements (Prospectus, CRR/CRD IV, AIFMD, CRA3 and Solvency II) and reporting requirements concerning SFI;
- develop possible solutions to address any inconsistencies within the existing due diligence, disclosure and reporting requirements.

The task force will establish a 'stocktake' aimed at providing a comprehensive picture of the regulatory and supervisory treatment of disclosure requirements in accordance with the relevant legislative framework, taking into account the following issues:

- i) consistent use of definitions;
- ii) objectives of the different regulations and frameworks (investor protection, retention requirements, collateral framework of central bank, other);
- iii) scope of application (geographical scope and transactions/products/assets covered);
- iv) requirements for private and bilateral transactions;
- v) reporting entities (issuer, sponsor, originator, original lender, servicer, other);
- vi) modalities for reporting (joint responsibility, entity defined by the regulation);
- vii) frequency of reporting (event based, only one shot or periodical);
- viii) information to be reported/published (transaction data, loan-level data, aggregated information, transaction summary, stress test information, investor reports, other);
and
- ix) enforcement regime.

Following the stocktaking exercise, the task force will develop possible solutions for any inconsistencies within the existing level-1 and level-2 due diligence and disclosure requirements (Prospectus, CRR/CRD IV, AIFMD, CRA3 and Solvency II) and reporting requirements concerning SFI. Once the mapping exercise is complete, the task force should suggest appropriate solutions to promote synergies across the EU and address any inconsistencies identified during the mapping exercise.

Recommendation 7: Disclosure requirements

Overall, the EBA considers the disclosure requirements in the current framework (CRR Article 409) in conjunction with the corresponding RTS (Article 22 and Article 23) to be appropriate and fit for purpose to ensure investor protection and financial stability. Therefore, the EBA does not recommend any changes.



Rationale

Originators and sponsors of securitisations should ensure that investors have access to all material information that is needed to perform a comprehensive and well-informed analysis of the risks arising in relation to the securitisation, where this analysis also takes the form of stress tests on the cash flows and collateral values supporting the underlying exposures. In principle, disclosure should include information on the credit quality and performance of the underlying assets on a loan-by-loan level. However, there are instances where the data may be provided on an aggregate basis. In assessing whether aggregate information is sufficient, factors to be taken into account shall include the granularity of the underlying pool and whether the management of the exposures in that pool is based on the pool itself or on a loan-by-loan basis. In this regard, the EBA considers the current requirements as sufficiently comprehensive and flexible to ensure that securitisation investors receive all material information on various types of transactions.

The EBA notes that the implementation of CRA3 provisions and other initiatives led by national authorities on the development of data templates for public and private transactions as well as established collateral frameworks of central banks have the potential to further improving the effectiveness of the framework, and to enhance consistency and transparency across the EU. The EBA consequently supports the current measures, and does not see any further need for additional measures beyond those already undertaken. However, the EBA considers the alignment of the different EU requirements to be helpful.

2.3 Appropriateness of due diligence requirements

In its call for advice, the Commission has asked the EBA to assess the appropriateness of disclosure requirements for sponsor and originator institutions to enable investor institutions to comply with due diligence obligations.

2.3.1 Adequacy of due diligence requirements (CRR Article 406 and the corresponding RTS)

Under Article 406 of the CRR, institutions investing in securitisations are required to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures based on all the materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitisation exposure and any information required to be disclosed by the originators.

The EBA is not aware of any specific regulatory due diligence requirements which apply in respect of other comparable investment products such as covered bonds and whole loan portfolios. Therefore, the due diligence requirements which apply to securitisations significantly exceed



what is required for other comparable investment products, potentially creating an uneven playing field, greater compliance burdens and disincentives for investors.

However, this cost is justified by the fact that the potential complexity of the product is high and requires sound and in-depth due diligence assessments.

Recommendation 8: Due diligence requirements

The EBA considers the due diligence requirements in the current framework (CRR Article 406 and Articles 15 and 16 of the corresponding RTS) to be sufficient and appropriate to enable investors to conduct appropriate due diligence.

Rationale

The due diligence requirements ensure a high level of safety for that current investors, and new investors consequently buy securitisations with a full understanding of the risk they are taking on and without a sole reliance on external ratings. Even though the requirements far exceed the requirements for comparable investment products, they are deemed appropriate because of the additional level of complexity inherent to securitisation positions compared to other investment products.

2.4 Additional risk weight and administrative penalties/measures

2.4.1 Adequacy of the level of additional risk weights and administrative penalties/measures

Pursuant to Article 407 of the CRR, an additional risk weight shall also be imposed in situations where an institution does not meet either the retention, due diligence or disclosure requirements in accordance with Article 409 of the CRR in any material respect by reason of the negligence or omission of that institution.

The consequence for non-compliance (where the relevant breach arose as a result of negligence or an omission of the relevant institution) is framed as a proportionate additional risk weight of no less than 250% of the risk weight (capped at 1 250%) which would otherwise apply to the relevant securitisation position, and provision is made for further increases with each subsequent infringement of the relevant provisions.

Pursuant to Article 407 of the CRR, the consequence for the investor of not complying in any material respect with the risk retention and due diligence requirements placed on it due to



negligence or an omission is the imposition of higher regulatory capital charges in respect of the non-compliant securitisation investment (ITS published in the OJ¹⁹).

Article 407 of the CRR allows for a reduction of the additional risk weight otherwise imposed under that article only where securitisation positions fall under the exemptions specified in Article 405(3) of the CRR.

In addition, in accordance with Article 67(l) of CRD IV, Member States must ensure that administrative penalties and other measures can be applied in situations where institutions are exposed to the credit risk of a securitisation without satisfying the conditions specified in Article 405 of the CRR. These measures and penalties must include a public statement, withdrawal of authorisation, administrative pecuniary penalties etc.

Recommendation 9: Adequacy of the level of additional risk weights and administrative penalties/measures

The EBA believes that the current sanctions in terms of additional risk weights and administrative penalties/measures are adequate.

Rationale

Given the low number of non-compliant cases (as highlighted in the compliance studies conducted by the EBA), the EBA believes that the sanctions in terms of additional risk weights imposed on an institution failing to meet the requirements provided in Article 405 (retention requirements), Article 406 (due diligence requirements) or in Article 409 (disclosure requirements) of the CRR and calculated by applying the formula in accordance with the approach specified in Article 245(6) and Article 337(3) of Regulation (EU) No 575/2013 serve as an adequate deterrent to violating risk retention, due diligence and disclosure requirements.

The EBA also believes that the administrative penalties and administrative measures that can be applied under CRD IV Article 67, where an institution is exposed to the credit risk of a securitisation position without satisfying the retention requirements in CRR Article 405, are adequate.

2.5 Regulatory approaches to risk retention, disclosure and transparency at an international level

¹⁹ http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:JOL_2014_166_R_0004



In its call for advice, the Commission has asked the EBA to take into account in its assessment the most relevant analysis at a global level as well as any international developments relating to risk retention, disclosure and transparency.

Australia

In April 2014, the APRA (Australian Prudential Regulation Authority) issued a discussion paper (DP) on simplifying the prudential approach to securitisation. Among other features discussed in the paper, the APRA proposed a simple ‘skin in the game’ requirement to mitigate any agency risks inherent in ‘originate to distribute’ lending. However, the requirement proposed²⁰ differed significantly from the ‘skin in the game’ requirement in force in the EU and the one in force in the US.

2.5.1 US securitisation risk retention, due diligence and disclosure rules

- **Risk retention requirements.** In the US, the proposed rules for risk retention requirements for ABS transactions were initially issued on 29 March 2011. On 21-22 October 2014, the rules were finalised and published by the “Joint Regulators”²¹. The final rules contain clarifications and revisions to the re-proposed rules released by the agencies on 28 August 2013.
 - General approach and jurisdictional reach
 - i) The final rules impose obligations on the ‘sponsor’ of a securitization 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 apply to the entity putting the securitisation transaction together, regardless of where that entity is located (although there is a limited exemption for certain foreign securitisations²²). A sponsor may allocate its risk retention obligations to originator(s)²³ of the securitized assets (or a majority-owned affiliate²⁴ of the originator) under certain circumstances and subject to certain conditions.

²⁰ The APRA is proposing that originating authorised deposit-taking institutions be required to retain at least 20 per cent of the junior or subordinated class in each of their securitisation structures.

²¹ The Board of Governors of the Federal Reserve System, FDIC, Department of Housing and Urban Development, Federal Housing Finance Agency, Office of the Controller of the Currency, and the SEC together form the ‘Joint Regulators’

²² The final rules provide a “safe harbor” provision intended for certain foreign transactions if a certain number of requirements are satisfied, such as (i) the securitisation transaction not being registered or not being required to be registered under the Securities Act, or (2) no more than 10% of the US dollar value of all classes of ABS interests in the transaction are sold or transferred to US persons or for the account or benefit of US persons and others.

²³ For the purposes of the final rules, an ‘originator’ is the original creditor of a loan or receivable (i.e. the entity that “created” the loan or receivable), and not a subsequent purchaser or transferee.

²⁴ A “majority-owned” affiliate is an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with this person. For the purpose of this definition, majority control means ownership of more than 50 percent of an entity, or ownership of any other controlling financial interest in the entity, as determined under the GAAP.



- Scope of application
 - i) The US rules apply 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 collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset’. There are various exemptions to the rules, such as US government-backed securitizations, pass-through resecuritisations, seasoned loans securitizations and securitizations of qualified residential mortgages. These securitization transactions are not subject to risk retention²⁵.
- Forms of retention
 - i) The US rules require the sponsor to hold an ‘eligible vertical interest’, i.e. the sponsor is required to retain no less than 5% of the face value of each ABS interest issued by the issuing entity; or the sponsor can hold an ‘eligible horizontal residual interest’ defined as an ABS interest in the issuing entity that has the most subordinated claim to payments of both principal and interest by the issuing entity; or a combination of the two. In addition, the US rules contain asset-specific approaches, which introduce additional flexibility in respect of some asset classes and market participants, provided that certain conditions are met²⁶.
- Holding period.
 - i) The minimum holding period for the retaining sponsor is at least five years for residential and commercial mortgage securitizations, and two years for all other securitizations²⁷.
- Exemptions
 - i) The final rules include a variety of exemptions from the risk retention requirements (0% risk retention), including exemptions for asset-backed securities that are collateralised exclusively by qualified residential mortgages (QRM), qualified commercial loans, qualified commercial real estate loans (QCRE) or qualified auto loans.

²⁵ See exemptions.

²⁶ Reference to footnote 21 above

²⁷ Sunset provisions on hedging and transfer restrictions. The final rules specify that the hedging and transfer restrictions expire once a certain set of conditions are met in the transaction.



- **Qualified residential mortgages.** The agencies are aligning the definitions of qualified residential mortgages (QRM) and qualified mortgages (QM). Specifically, Section 15G of the Dodd-Frank Act requires that the scope of QRM be no broader than that of QM, which means that QRM require features such as (i) regular periodic payments, (ii) maximum loan terms of 30 years, (iii) no negative amortisation, interest only or balloon features and (iv) total debt-to-income ratio ('DTI') that does not exceed 43%, including mortgage-related obligations;
- **Qualified commercial real estate loans.** . For a commercial real estate (CRE) loan to qualify as a qualified commercial real estate (QCRE) loan, the loan must meet a certain set of underwriting standards such as (i) each QCRE loan must be secured by an enforceable first lien, (ii) based on the past two years' actual performance and two years of projection, the borrower will have a debt service coverage ratio (DSCR) of 1.5 or greater if the loan is a qualifying leased CRE loan, a DSCR of 1.25 or greater if the loan is a qualifying multi-family loan, or a DSCR of 1.7 or greater if the loan is any other type of CRE loan, (iii) a fixed rate or adjustable rate but only for specific conditions, (iv) a minimum term of 10 years and term does not exceed 25 years (or 30 years for qualifying multi-family home), (v) payments on a monthly basis, (vi) maximum LTV of 65% and maximum CLTV²⁸ (combined LTV) of 70%;
- **Qualified automobile loans.** For an ABS comprised solely of automobile loans to qualify for risk retention exemption/reduction, these loans must meet underwriting standards such as (i) a loan term of maximum five years, (ii) a fixed interest rate, (iii) amortisation on a straight-line basis, (iv) a DTI not greater than 36%, (v) loans needs to be current at the time of the securitisation, (vi) all loans must be qualified for exemption (not just a portion of the loans);
- **Qualifying commercial loans.** For ABS comprised solely of commercial loans to qualify for risk retention exemption/reduction, these loans must meet different underwriting standards criteria such as (i) a loan term of maximum five years, (ii) a fixed interest rate, (iii) straight-line amortisation fully amortised over the term of the loan, (iv) a liability ratio of 50% or less, leverage ratio of 3.0 or less and a DSCR of 1.5 or more over the last two fiscal years;
- **Student loans ABS.** The risk retention requirement is reduced for Federal Family Education Loan Program (FFELP) ABS. Specifically, securities

²⁸ The definition of CLTV refers to any junior-lien mortgage loan that is secured by the 'same property.' A mezzanine loan that is secured by equity interests in the mortgage borrower should not be included in this calculation.



backed by FFELP loans carrying a guarantee percentage rate of 100%, 98% and 97% have a risk retention requirement of 0%, 2% and 3% respectively.

- Penalty
 - i) Under the US rules, failure to comply with the risk retention requirements would be a violation of the US Securities Exchange Act of 1934 and penalties for sponsors could include civil penalties (fines), injunctions etc.

Table 2, below, summarises the main differences between the EU Regulation and the US rules.

Table 2: Comparison of international developments on risk retention

	EU requirements, CRR	US final rule
General approach: Who has to comply with the retention requirements?	Relevant entity assuming exposure to credit risk, e.g. investor EU-regulated banks, investment firms and consolidated entities, AIFMs and insurers.	Sponsor — organises/initiates securitisation via transfer of assets. Entities within jurisdiction of relevant US agencies.
Jurisdictional scope	Global application; requirements triggered by relevant involvement of relevant entity.	Unclear, non-US sponsors may be within jurisdiction in certain circumstances but safe harbour for certain non-US deals.
Scope of application: Which deals?	Securitisation as defined in Article 4(61) of the CRR. Limited grandfathering, pre-2011 deals (including issues under existing programmes) within scope from end of 2014 if new assets added or substituted.	Transaction involving the issue and sale of ABS. Widely defined, require to involve security. Synthetic securitisations are not within the scope. Issues until at least October 2016 are grandfathered.
Retainer: Who is required to retain?	One out of the originator, sponsor or original lender. Split proportionally between multiple originators/sponsors but flexibility for one entity to hold in certain circumstances.	Sponsor in general, but can allocate proportionate share to originator in certain cases under standard holding options. If multiple sponsors, one required to retain.
Forms of retention	Five permitted holding options: vertical slice, first loss, representative sample, seller share for revolving asset pool, first loss in each asset. Flexibility provided regarding forms that may be used to hold retained interest, including unfunded forms (non-banks need to be fully cash collateralised) and over-collateralisation.	Base case/standard holding options include vertical slice, first loss or any combination of these (L-shape). No unfunded forms, no OC.
Interest level: Calculation basis	5% of nominal value in all cases.	5% fair value for first loss option and 5% nominal value for vertical slice option. Reduction for qualifying asset deals.



	EU requirements, CRR	US final rule
Holding period	Lifetime of transactions.	Minimum holding period for the retaining sponsor is at least five years for residential and commercial mortgage securitisations, and two years for all other securitisations. Set of sunset provisions on hedging and transfer restrictions (extend or reduce the holding period depending on the asset class).
Exemptions	Limited exemption: certain correlation trading activities, deals backed by government claims.	Various exemptions, including for deals backed by QRMs or government claims, also for GSE (government-sponsored enterprises)-guaranteed mortgage-backed securities (MBS), seasoned loan deals, certain resecuritisations; effective exemptions for qualifying asset deals.
Penalty	Under the CRR, proportionate additional risk weight with respect to relevant securitisation positions. Under CRD IV Article 67(l), administrative penalties and other administrative measures	Penalties for sponsors could include civil penalties (fines), injunctions etc.

- **Due diligence and disclosure requirements** in the context of securitisation transactions subject to retention requirements.
 - There are no investor due diligence provisions similar to those in Europe.
 - The final rules require that the sponsor arrange for written disclosures to be provided to potential investors within a reasonable period of time prior to the sale of the related ABS and, upon request, to the SEC (U.S. Securities and Exchange Commission) or appropriate federal banking agency (if any) under the title 'Credit Risk Retention' as follows:
 - i) In the case of retention via horizontal interest, information such as (i) the fair value of the horizontal residual interest that the sponsor expects to retain at the closing of the transaction as well as the methodology used and the key inputs and assumptions (such as discount rates, LGD (Loss Given Default) [recovery], default rates etc.), (ii) a description of the material terms of the eligible horizontal residual interest to be retained.

The same information will also be requested a reasonable period of time after the closing of the securitisation.



- ii) In the case of retention via vertical interest, information such as (i) the form of the eligible vertical interest, (ii) the percentage retained and (iii) a description of the material terms of the retained slice.
- For registered ABS²⁹ only, issuers³⁰ are required:
 - i) to perform a review of assets underlying an ABS which is designed and effected to provide reasonable assurance that the disclosure regarding the pool assets in the prospectus is accurate in all material respects; and
 - ii) to disclose the nature, findings and conclusions of this review.
- Third parties may be engaged to conduct portions of the due diligence:
 - i) if the issuer attributes findings to the third party, the third party must consent to being named as an 'expert' in the prospectus;
 - ii) the issuer may rely on a review by an affiliated (but not an unaffiliated) originator.
- If assets in the pool deviate from disclosed underwriting criteria, the issuer must disclose:
 - i) how the assets deviate, and the amount and characteristics of non-conforming assets;
 - ii) which entity determined that the non-conforming assets should be included in the pool; and
 - iii) if compensating or other factors were used to determine that assets should be included.
- This rule will affect entities that issue in the US and may influence the way in which they present information in Europe.

2.5.2 Lack of consistency across jurisdictions

While the thrust of the regulations is similar (retention, disclosure, transparency etc.), there are several differences in the general approach, retention methods and the scope of application (with multiple exemptions in the US compared to EU legislation).

²⁹ Registered ABSs are defined as a SEC-registered public offering of ABS. The final rules will not apply to unregistered ABS offerings relying upon Rule 144A at this time

³⁰ For rule 193, issuers are the depositors or sponsors of the securitisation. A sponsor typically initiates a securitisation transaction by selling or pledging to an SPC financial asset that the sponsor has either originated itself or has purchased in the secondary market.



The review completed above highlights significant inconsistencies between the two frameworks (EU and US rules) for retention requirements, as well as proof of compliance. First of all, the EU's risk retention rules address those investing in (or otherwise assuming an exposure to) a securitisation while the US rules address the entity putting the securitisation transaction together, regardless of where that entity is located. However, as discussed earlier, the EBA is recommending the introduction of the direct approach (requirement on the retainer) to complement the indirect approach.

The lack of consistency between both frameworks will most likely affect the EU securitisation market. It is difficult to provide precise figures as to the level of reliance on US offering regimes (such as Rule 144A, Regulation D or Section 4(2) of the US Securities Act of 1933) by European issuers; however, calculations by AFME (Association for Financial Markets in Europe), based on Dealogic data, suggest that up to 25% of the total issuance of EU-originated securitisations was offered in reliance on Rule 144A prior to the financial crisis. In addition, the Rule 144A regime has played an important role in recent years in the success of UK-originated RMBS issues and certain other transactions (for example auto and credit card ABS).

Given the way in which the EU regime and the US regime are set up, in general, it will be necessary for issuers to comply with both the EU and the US requirements if they wish to arrange deals on a cross-border basis. The direct implications of this means that the ability to comply with both regimes bears compliance cost which might not make the transaction economically feasible.

The potential liquidity implications, as well as the critical importance of preserving securitisation as a global funding tool for real economy assets, mean that the ability to comply with both regimes in a manner which does not compromise the economic efficiency of relevant cross-border transactions is an area of key concern.

In addition, the fact that the retention requirement is largely in place in Europe and not required in the US until at least the end of 2016³¹ suggests that many US securitisations are and will continue to be unacceptable to European investors, i.e. non-compliant with the EU regulatory framework. This could discourage and limit the entrance of new investors in the securitisation market in Europe and current investors (banks, insurers, investment firms) will come to realise these limitations to their compliant investments range, which could alter the securitisation investments' relative value compared to other similar secured funding products.

To ensure a global level-playing field and support the cross-border securitisation market and the liquidity for the product, the EBA believes that the retention requirements should be implemented globally in a consistent way.

Recommendation 10: Convergence of the retention rules regulatory frameworks

³¹ It is expected that the rules in the Federal Register will be published before the end of 2014. One year later, the rules will apply to new ABS backed by residential mortgage loans and two years later the rules will apply to other new ABS.



The EBA supports the development of more alignment and consistency between regimes and supports the IOSCO peer review which was launched in spring 2014 to assess the implementation of the G20 commitments at a global level, and to encourage further convergence between regimes.

Rationale

The EU regime and the foreign legislation, if not harmonised, may drive a real wedge in the global securitisation markets and may further reduce EU issuers' ability to benefit from the global investor base and EU investors' ability to benefit from global securitisation investments; therefore reducing the competitiveness of the EU financial industry and its ability to be engaged in the global securitisation market.

3. EBA recommendations

3.1 EBA response to the Commission's call for advice of December 2013 related to Article 512 of Regulation No 575/2013/EU

Recommendation 1: Indirect approach with the direct approach to be used as complementary

Taking into account the positive impact of the current framework on EU markets, the EBA recommends keeping the indirect approach for now and implementing a complementary direct approach: in addition originators/sponsors/original lenders should be obliged to publicly disclose on the detailed retention form using a standardised format to create more transparency and certainty for the investors and to thereby facilitate the investors' due diligence.

Rationale

The 'indirect' approach places the onus on the investors and consequently encourages investors to only buy securitisation exposures following proper due diligence and once they fully understand the risk they are taking on. Therefore, placing the requirement on the investors rather than on the originator has the potential of serving as an additional tool to enhance the level of sophistication of investors over time. Furthermore the 'indirect' approach has the merit of increasing the ability of NCAs to enforce risk retention provisions effectively.

On the other hand, the 'direct' approach, which places the retention requirement obligation directly on originators, sponsors and original lenders instead of the investor institutions, could, while causing potential additional costs for originators, original lenders and sponsors, reduce compliance costs and improve legal certainty for investors, thereby encouraging new securitisation investors to invest. Moreover, the EBA believes that the enforcement of disclosure requirements must be possible.

Given the approach adopted in some major jurisdictions, a move towards the direct approach could also bring some benefits in terms of cross-border consistency.

Recommendation 2: Forms of retentions

The EBA believes that, other than the five forms of risk retention already available, no other form should be considered at this time and recommends further assessment of the effectiveness of the five forms already in place.

Rationale

The options provided in Article 405 of the CRR are well established and, according to feedback received by stakeholders and national supervisors, seem to work well and are deemed sufficient.

The EBA stresses that greater choice with additional forms of retention may have some drawbacks: because originators, original lenders and sponsors are given a greater choice with regard to how to retain risk, their chosen form may not be as effective in aligning interests and mitigating risks for investors as the options provided for in the CRR. Furthermore, the special features of an additional “L-shape” retention option would add to the complexity of measuring the net economic interest.

Recommendation 3: Alternative mechanisms to achieve the alignment of interests

The EBA believes that alternative mechanisms for aligning interests other than risk retention should not be considered as a substitute for risk retention requirements.

Rationale

While the alternative mechanisms specified above are considered helpful as a complement to risk retention requirements, the EBA does not believe that there is sufficient evidence supporting the use of these alternative mechanisms as a substitute or demonstrating that they are equivalent to the current retention options in place regardless of the asset class or securitisation structure.

Recommendation 4: Retention on a consolidated basis

The EBA believes that it is essential that consolidation be accomplished with regard to the scope of supervision on a consolidated basis (Article 405(2) of the CRR) and believes that the scope of consolidation should not be expanded.

Rationale

The EBA believes that it must be possible to enforce disclosure requirements. Therefore, the retaining entity needs to be included in the scope of supervision on a consolidated basis. Furthermore, retention within the scope of supervision on a consolidated basis will ensure transparency on retainers and the possible use of regulatory arbitrage relating to the retention position. This approach is also consistent with the EBA’s observations and findings outlined in its Final Report to the European Commission on the perimeter of credit institutions established in the EU Member States.

Recommendation 5: Exemptions and exceptions to Article 405 of the CRR

The EBA believes that there are sufficient ways of complying with the retention rule; therefore, the EBA does not recommend allowing for any further exemptions and/or exceptions to Article 405(3) and Article 405(4) of the CRR at this time.

However, the EBA would recommend further assessing the possibility of introducing an ‘exceptional circumstances’ provision whereby under certain circumstances (such as the insolvency of the retainer), the retainer could be changed during the life of a securitisation transaction to ensure that the retainer is always the most appropriate entity to whom the interests of the investors should be aligned.

Rationale

The EBA believes that providing further exceptions could lead to abuse of the rules and that securitisation transactions could specifically be structured to meet the possible exemptions. Furthermore, as mentioned before, the EBA does not believe that any alternative mechanisms can be used as a substitute or are equivalent to the current retention options in place regardless of the asset class or securitisation structure.

Recommendation 6: Potential loopholes

The EBA believes that, for the purposes of the retention requirements, the ‘originator’ definition in CRR Article 4(13) should be narrowed down and defined in further detail to reduce the potential misuse of the retention requirements via legal definition loopholes and to ensure real alignment of interests between the originator and investors.

Rationale

As a result of the wide scope of the definition of ‘originator’ in Article 4(1)(13) of the CRR, it is possible to structure securitisation transactions so as to meet the legal requirements of the regulation without following the ‘spirit’ of the regulation and which, in fact, do not always align the interests of the most appropriate party to retain (originator, original lender or sponsor) with the interests of the investors.

The EBA believes that the entity claiming to be the ‘originator’ should in principle be of real substance and should always hold some actual economic capital on its assets for a minimum period of time.

If necessary, the EBA could do further work on narrowing down the scope of the originator definition.



Recommendation 7: Disclosure requirements

Overall, the EBA considers the disclosure requirements in the current framework (CRR Article 409) in conjunction with the corresponding RTS (Article 22 and Article 23) to be appropriate and fit for purpose to ensure investor protection and financial stability. Therefore, the EBA does not recommend any changes.

Rationale

Originators and sponsors of securitisations should ensure that investors have access to all material information that is needed to perform a comprehensive and well-informed analysis of the risks arising in relation to the securitisation, where this analysis also takes the form of stress tests on the cash flows and collateral values supporting the underlying exposures. In principle, disclosure should include information on the credit quality and performance of the underlying assets on a loan-by-loan level. However, there are instances where the data may be provided on an aggregate basis. In assessing whether aggregate information is sufficient, factors to be taken into account shall include the granularity of the underlying pool and whether the management of the exposures in that pool is based on the pool itself or on a loan-by-loan basis. In this regard, the EBA considers the current requirements as sufficiently comprehensive and flexible to ensure that securitisation investors receive all material information on various types of transactions.

The EBA notes that the implementation of CRA3 provisions and other initiatives led by national authorities on the development of data templates for public and private transactions as well as established collateral frameworks of central banks have the potential to further improving the effectiveness of the framework, and to enhance consistency and transparency across the EU. The EBA consequently supports the current measures, and does not see any further need for additional measures beyond those already undertaken. However, the EBA considers the alignment of the different EU requirements to be helpful.

Recommendation 8: Due diligence requirements

The EBA considers the due diligence requirements in the current framework (CRR Article 406 and Articles 15 and 16 of the corresponding RTS) to be sufficient and appropriate to enable investors to conduct appropriate due diligence.

Rationale

The due diligence requirements ensure a high level of safety for that current investors, and new investors consequently buy securitisations with a full understanding of the risk they are taking on and without a sole reliance on external ratings. Even though the requirements far exceed the requirements for comparable investment products, they are deemed appropriate because of the



additional level of complexity inherent to securitisation positions compared to other investment products.

Recommendation 9: Adequacy of the level of additional risk weights and administrative penalties/measures

The EBA believes that the current sanctions in terms of additional risk weights and administrative penalties/measures are adequate.

Rationale

Given the low number of non-compliant cases (as highlighted in the compliance studies conducted by the EBA), the EBA believes that the sanctions in terms of additional risk weights imposed on an institution failing to meet the requirements provided in Article 405 (retention requirements), Article 406 (due diligence requirements) or in Article 409 (disclosure requirements) of the CRR and calculated by applying the formula in accordance with the approach specified in Article 245(6) and Article 337(3) of Regulation (EU) No 575/2013 serve as an adequate deterrent to violating risk retention, due diligence and disclosure requirements.

The EBA also believes that the administrative penalties and administrative measures that can be applied under CRD IV Article 67, where an institution is exposed to the credit risk of a securitisation position without satisfying the retention requirements in CRR Article 405, are adequate.

Recommendation 10: Convergence of the retention rules regulatory frameworks

The EBA supports the development of more alignment and consistency between regimes and supports the IOSCO peer review which was launched in spring 2014 to assess the implementation of the G20 commitments at a global level, and to encourage further convergence between regimes.

Rationale

The EU regime and the foreign legislation, if not harmonised, may drive a real wedge in the global securitisation markets and may further reduce EU issuers' ability to benefit from the global investor base and EU investors' ability to benefit from global securitisation investments; therefore reducing the competitiveness of the EU financial industry and its ability to be engaged in the global securitisation market.

Annex I

Figure 1 below provides an example of where the derogation in Article 3(4)(a), (EU) No 625/2014 can be employed to avoid the intention of Article 405 of the CRR.

