RISK RETENTION: A RANGE OF POTENTIAL SOLUTIONS INVOLVING THIRD PARTIES

It is almost fifteen years since the EU's risk retention (or "skin-in-the-game") rules were developed in response to concerns that interests of investors and originators were insufficiently aligned. In that time, the market has adapted and developed a number of solutions to adhere to the rules in situations where there may no longer be a substantial entity that was involved in the creation of the exposures to perform the risk retention function. In this article, we look at some of those solutions and the legal issues arising from them.

THE HISTORY

When Article 122a of the Banking Consolidation Directive was adopted in September 2009, it required credit institutions investing in securitisations to ensure that "the originator, sponsor or original lender has explicitly disclosed to the credit institution that it will retain, on an ongoing basis, a material net economic interest which, in any event, shall not be less than 5%". It quickly became known as the "skin-in-the-game" rule, designed to make sure that lenders would be forced to hold on to some of the risk associated with the assets that they originated, in the hope that this would incentivise the securitisation of high-quality assets. The rules have been updated a number of times since then (mostly to expand the scope of entities caught by the rule), but the substance of the 5% requirement has remained broadly intact. However, the relative stability of basic requirements belies the steady change in compliance methods that have been seen in the market over the years.

By and large, these developments were borne out of a need to apply existing rules to novel situations. It quickly became clear that there were multiple portfolios in need of financing via securitisation where there was no longer a substantial entity that was involved in the creation of the exposures, and so no obvious single candidate to fulfil the role of 'originator' or 'original lender'. In other cases, the portfolio was held by complex or thinly capitalised entities (such as some funds) that might not be considered entities of substance for the purposes of the rules. Faced with these circumstances and the need to adhere to the letter and spirit of the rules, the market gradually developed new ways of thinking about which entity could hold the risk retention piece in a compliant manner. We set out some of the methods that we have seen in the market, and explore the legal issues arising from them, below.

This is an update of an article originally published on 5 June 2023 as part of our publication "Securitisation markets and regulation: choosing different paths?", accessible here.

Key Issues

- Where there is no longer a substantial entity that was involved in the creation of the exposures to perform the risk retention function, a third party may in some cases perform the risk retention function instead.
- Approaches to risk retention in these cases will need to be carefully considered to comply with both the letter and spirit of the rules.
- Most such approaches involve such entity taking on the role as a 'limb (b) originator' due to regulatory barriers making the sponsor route less flexible and practical.

Who Can Be an 'Originator'?

The term "originator" is defined in Article 2(3) of the EU Securitisation Regulation and Article 2(3) of the UK Securitisation Regulation as "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 exposures being securitised;*

or

(b) *purchases a third party's exposures on its own account and then securitises them;"*

Limb (b) has garnered the most attention, particularly, where the original creditor of the exposure is not involved in the later securitisation.

The key legal issue here revolves around what it means for an entity to purchase exposures "on its own account". None of the UK Securitisation Regulation, EU Securitisation Regulation nor any of their corresponding guidance define the term "for its own account". There is, however, a helpful analogy with the concept of "dealing on own account" under Article 4(1)(6) of the Markets in Financial Instruments Directive ("**MiFID**"), being the activity of "trading proprietary capital resulting in the conclusion of transactions in one or more financial instruments". In the context of MiFiD, that would be contrasted with "executing orders on behalf of clients", i.e. acting as a riskless intermediary. With this in mind, we can therefore consider a few methods for identifying an entity that can appropriately be a "limb (b) originator".

The purchase method

It is possible for an entity to be regarded as a "limb (b) originator" as long as it is exposed to the risk of the exposures on a principal basis. There is no suggestion in the text to support any assertion that the originator must become the 'lender of record' under the terms of the underlying exposures. To that end, the purchase of the beneficial interest in the asset portfolio is sufficient to show that the entity "purchases a third party's exposures on its own account" and could therefore be deemed a limb (b) originator, whether or not such purchase is perfected by giving notice to underlying obligors.

There are also other practical issues to consider. If an entity is to be deemed a limb (b) originator, it must be the entity who "securitises" the exposures. As such, that entity would typically be expected, either itself or through its agents, to instruct the creation of the issuer special purpose vehicle and other third parties such as rating agencies. It would also typically need to carry out suitable due diligence on the underlying exposures and, in the case of public securitisations, be involved in the marketing of the deal to investors. Any would-be limb (b) originator must therefore be willing and capable of performing these roles.

The commitment method

An entity can be considered to be a limb (b) originator even if the exposures are not "purchased" in the entity's own name, either legally or beneficially, as long as the entity acquires the risk associated with the exposures. Practically speaking, you would normally expect to see this risk reflected on the balance

sheet (both for accounting and regulatory capital purposes), particularly for regulated entities. The term “purchases” (as used in Article 2(3) of the Securitisation Regulations) is widely viewed in the market as a requirement that a limb (b) originator be exposed to the credit risk of exposures it is transferring into a securitisation scheme, rather than being restricted to a “purchase” in the technical legal sense. For example, if a regulated entity is required to post regulatory capital in respect of the risk associated with a pool of exposures, that entity is clearly “on risk”, irrespective of whether any legal or beneficial title has passed to that regulated entity.

For example, the entity intending to act as limb (b) originator could generally be considered “on risk” from an accounting perspective as of the time that entity was committed (with little or no conditionality) to purchase the relevant exposures at a particular price, perhaps by way of a binding commitment letter. The full sale documentation need not necessarily be finalised or executed at this time, and the actual legal purchase of such exposures need not necessarily have completed. This could be the case as long as such entity remains exposed to the financial risk in the period between its commitment becoming effective and the completion of the sale of the exposures.

In particular, there should be no mitigant or ability for the putative buyer to back out based on the exposures’ performance in the interim period (for example, a market out or a mechanic adjusting the purchase price based on the exposures’ performance as at the transaction closing date). Moreover, the commitment to purchase should not be conditional upon the securitisation taking place, meaning the putative buyer assumes the associated execution risk.

The commitment to purchase can include a mechanism under which the on-risk entity acting as limb (b) originator may procure that the loans are legally purchased on its behalf by a third party nominated by the entity. This might be useful if there are legal barriers to the entity acting as limb (b) originator holding legal title to the exposures (e.g. a statutory requirement under the governing law of the exposures requiring the lender of record to be an entity in the jurisdiction). When the sale takes place, the loans may pass straight from the seller to the acquisition vehicle, which may be the securitisation SPV.

The result is that an entity can act as a limb (b) originator without ever having had legal ownership of the underlying exposures (although it must have borne credit risk associated with them). Despite this, the requirement for the originator to “securitise” the exposures nonetheless means that the entity must play a key role in the securitisation transaction. It would therefore still need to be instrumental in bringing the deal to market. For this reason, many entities looking to act as limb (b) originators in the public securitisation market have held roles as arranger or manager on the related securitisation.

The historic portfolio risk method

More recently, the start of the “on risk” period for the entity seeking to act as limb (b) originator has been treated by some market participants as beginning on the last day on which the proposed limb (b) originator has knowledge of the portfolio. If the entity is not supplied with up-to-date information on the portfolio performance after a particular date – we’ll call this the “Cut-Off Date” – but they go on to commit to buy the portfolio anyway, the logic is that they will be taking the economic risk of any poor performance that may have occurred from the Cut-Off Date and not just from the date they become bound by the

commitment. In other words, they will acquire retrospective risk on the portfolio for their own account.

This approach might be preferred by some entities. If the entity can be regarded as being "on risk" as of the Cut-Off Date, finalising a commitment to purchase well in advance of the securitisation becomes less important. This means that the commitment to purchase can be made much closer to the securitisation closing, potentially after the securitisation has priced, albeit it remains crucial that the entity is "on risk" prior to the securitisation closing. When contrasted with the 'purchase method' or the 'commitment method' above, both of which require the entity to disregard the viability of the securitisation going ahead, this 'historic portfolio risk' method is more closely tied to the progress of the securitisation if there is no commitment to purchase until the transaction has priced – thereby drastically reducing the execution risk taken by the limb (b) originator. It also has the advantage of reducing the period of time for which the relevant entity may need to bear any related regulatory capital costs.

From a practical perspective, however, this method can be slightly more difficult to implement. It is of the utmost importance that the entity is not able to act on any information relating to the portfolio after the Cut-Off Date, which in some cases can cause obstacles if the relevant entity or its affiliates have a role in marketing the securitisation. This method is also less 'tried and tested' than the purchase method or the commitment method, so it is not clear how regulators will feel about it. However, it has been used on a number of public transactions, and is based on the same fundamental principles as the other methods – namely, the limb (b) original entity being on risk for its own account prior to the securitisation taking place.

How long must the entity be "on risk"?

One question that frequently arises is how much time must elapse between the entity first being "on risk" and the securitisation taking place. There is not a single rule here, and none of the relevant legislation or guidance specifies a particular holding period. The answer largely depends upon how the entity's risk manifests itself.

For example, if the risk is demonstrated by a regulated entity posting regulatory capital against the risk, this provides strong evidence that the entity has been "on risk" even if capital has been posted for a relatively short period. If the risk is demonstrated by way of frequent mark-to-market valuations with consequential regulatory reporting costs, evidence that the entity has been "on risk" can be derived from fluctuations in the price.

If the intention is to demonstrate the risk solely by the entity taking on the risk of the underlying exposures falling to pay when due, care must be taken to ensure the risk being taken is real and not illusory.

For example, if the underlying exposure consists of a large loan repayable by instalments, and the period the proposed limb (b) originator is "on risk" does not include any payment dates on that loan, there is no real possibility of the asset suffering a default during that time and the risk taken is largely theoretical.

What About Acting as a 'Sponsor'?

No matter which of the above three methods are considered, structuring a transaction so that an entity involved in the creation of the exposure can reasonably be considered to be an "originator" requires a considerable amount of upfront thought and documentation, as well as the would-be originator's willingness to bear the economic risk associated with the exposures. In some cases, it can appear simpler for the risk retention holder to instead act as a "sponsor" instead.

There are, however, significant regulatory reasons why this is impractical, since acting as a sponsor is restricted to certain types of institutions (generally credit institutions and investment firms) and there are greater difficulties with cross-border recognition of sponsors because of licencing requirements (e.g. a UK investment firm would not be recognised as a valid sponsor in the EU if it did not also hold an EU MiFID authorisation).

Assuming those regulatory barriers are not an issue, both the UK Securitisation Regulation and the EU Securitisation Regulation require that a sponsor "establishes and manages" a securitisation transaction, or establishes a securitisation and delegates the day-to-day active portfolio management involved in that securitisation to an entity authorised to perform such activity.

For a proposed sponsor that was intending to act as an arranger, the "establishes" limb can often be met with relatively little additional work. The second limb of "manages" can be more difficult, as it would require ongoing involvement in the transaction after the distribution of the relevant notes: something many arrangers prefer to avoid. That ongoing management role would likely comprise two strands. The first such strand is a management function in respect of the exposures. In a static pool, this could be achieved by acting as servicer, or exercising some form of influence over the servicer's decision-making, such as participation in a committee or having defined consultation rights. In an actively-managed pool, the sponsor would generally be expected to have a significant role in the relevant investment decisions. The second strand is management of the transaction structure beyond the securitised exposures, particularly with respect to the transaction's liabilities: this could include acting as cash manager or paying agent, or taking on a role in addressing queries from investors.

In the current market, it is more common for risk retention entities not involved in the creation of the exposures being securitised to act as limb (b) originators than as sponsors. However, the sponsor option remains open to market participants, and may be the most logical route to follow in certain circumstances – in particular where an obvious candidate to take on the role of 'limb (b) originator' exists but for any reason does not wish to hold the risk retention itself.

The Future

When the risk retention rules were first developed, there was a great deal of anxiety about how the rules would affect the market and whether securitisations could be rendered impossible in certain circumstances. While some concerns remain, the ability of the market to adopt new approaches in compliance with the letter and spirit of the regulations has ensured that securitisation remains a viable route to raising capital against a wide range of portfolios. However, the rules can function as traps for the unwary, and their requirements are not as black-and-white as they may first seem. As the

market continues to grow accustomed to the new regulations (including applicable technical standards and regulatory guidance), and newer transactional solutions arise, we fully expect to see further, deeper and richer analysis being undertaken and new structured solutions being considered by market participants – but any such approaches will need to be carefully considered.

C L I F F O R D
C H A N C E

CONTACTS

Andrew Bryan
Knowledge Director, London

T +44 20 7006 2829
E andrew.bryan@cliffordchance.com

Kevin Ingram
Partner, London

T +44 20 7006 2416
E kevin.ingram@cliffordchance.com

Mark McGuire
Senior Associate, London

T +44 20 7006 3603
E mark.mcguire@cliffordchance.com

Maggie Zhao
Partner, London

T +44 20 7006 2939
E maggie.zhao@cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

© Clifford Chance 2023

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Delhi • Dubai • Düsseldorf • Frankfurt • Hong Kong • Houston • Istanbul • London • Luxembourg • Madrid • Milan • Munich • Newcastle • New York • Paris • Perth • Prague • Riyadh • Rome • São Paulo • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

AS&H Clifford Chance, a joint venture entered into by Clifford Chance LLP.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.