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From:	Commission
To:	Working Party on Financial Services (Securitisation)
Subject:	COMMISSION SERVICES NON-PAPER RISK RETENTION

COMMISSION SERVICES NON-PAPER

RISK RETENTION

7 APRIL 2017

1. Introduction and rationale for the drafting proposal

It is crucial for the functioning of the securitisation market to ensure that issuers of securitisations have "skin-in-the-game" and their interests are thus aligned with those of the investors. It is for this reason that in 2009 the strictest risk retention regime among all major jurisdictions¹ was introduced in EU law (directive 2009/111/EC – CRD2).

In reviews (by CEBS and EBA) and in three public consultations (COM, ECB-BoE, EBA), EU supervisors have unanimously argued for keeping the current retention framework unchanged. This is based on the international standards developed by BCBS and IOSCO. In a recent non-paper on risk retention², the ECB concludes that: *"an increase of the 5% minimum retention rate is not warranted. On the one hand, the 5% rate has been calibrated taking into account a broad range of ABS, including problematic ones originated in the US, while European securitisation has shown a very good overall performance. On the other hand, a retention rate increase would place European issuers at a disadvantage and very negatively impact the future viability of securitisation in Europe."* **There is a strong and wide consensus around the adequacy of the current risk retention framework.**

Any change to the risk retention framework would thus need to be supported by careful analysis and based on strong evidence supporting the proposed change. Such evidence has not been brought forward. The annexes of this non-paper explain in detail the reasoning behind this position³.

The **European system of financial supervision**, and in particular the ESRB in relation to macroprudential aspects and the EBA in relation to microprudential aspects, **has the right skillset and mandate to analyse** the retention framework and to recommend changes, if convincing evidence supporting such changes is found.

The credit standards requirements in article 5a and the STS criterion prohibiting cherry-picking of underlying loans are sufficient to address any problem of cherry-picking in the securitisation market. **These safeguards could however be strengthened** by giving supervisors the power to investigate potential cases of cherry-picking and sanction any wrongdoing.

On this basis, **a four-pronged approach** to the risk retention framework could be considered:

- 1) Leave the retention levels, as proposed by the Commission and agreed to by the Council, unchanged;
- 2) Give the ESRB a stronger mandate to assess material risks to financial stability arising from securitisation and to propose correcting measures, including a possible modification of retention levels – see the drafting proposal in section 2;

¹ The EU is the only major jurisdiction where a 5% mandatory risk retention requirement applies to the whole market, with no exception. This is not the case in the US, Japan, Canada or Australia.

² "Issues on risk retention", ECB non-paper, September 2016.

³ Please see Annexes I and II at the end of this document.

- 3) Introduce potential fines for cherry-picking of securitised assets by issuers – see the drafting proposal in section 3;
- 4) Ensure the definition of originator is not abused to circumvent the risk retention requirements – see the drafting proposal in section 4.

2. A stronger mandate for the ESRB

The ESRB could be given a stronger mandate to investigate and recommend modifications to the retention framework. Two conditions are however important to make the mandate operational:

- a) **the timing** of ESRB actions should be left unrestricted. The ESRB should be in charge of deciding if and when action must be taken. Requiring it to assess retention levels every two years would create unmanageable uncertainty in the market⁴, jeopardising the ultimate objective to revive EU securitisation, and would be resource intensive for the ESRB, with no clear benefit.
- b) **the choice of tools** used to tackle material risks to financial stability arising from securitisation markets should be left unrestricted. Effective macroprudential tools to deal with market overheating have been developed via extensive research before being implemented in Basel standards and EU legislation. Risk retention levels are not necessarily the most effective tools. Indeed, while an increase in risk retention levels may reduce securitisation issuance, other funding tools (e.g. bank bonds) could continue to feed asset price increases and market overheating unless the underlying drivers of such overheating are tackled. The underlying drivers may be better tackled with tools such as higher risk weights and loan-to-value limits, for example. It is the ESRB that should use its expertise and identify which are the most effective tools to tackle the identified drivers.

Drafting proposal for lines 575-583, 585 (based on the ECON text)

Article 16 a

Macro-prudential oversight of the securitisation market

2. In order to contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system and taking into account macroeconomic developments, so as to avoid periods of widespread financial distress, the ESRB shall continuously monitor developments in the securitisation markets. Whenever the ESRB considers it necessary, in order to highlight financial stability risks, the ESRB shall, in collaboration with EBA, publish a report on the financial stability implications of the securitisation market. If material risks are observed, the ESRB shall provide warnings and, where appropriate, issue recommendations for remedial action in response to these risks pursuant to Article 16 of Regulation (EU) No 1092/2010, including on the appropriateness of modifying the risk retention levels, to the Commission,

⁴ Small players with less access to capital markets would be disproportionately hit by constant potential changes in the retention levels they would need to fund. Business plans can hardly be drawn if capital needed can double or quadruple every second year.

the ESAs and to the Member States. The Commission, the ESAs and the Member States shall take action where necessary, pursuant to recital 20 of Regulation (EU) No 1092/2010.

~~Following the publication of the biennial report on the securitisation market referred to in Article 29, and in order to reflect changes in market circumstances, to prevent asset bubbles from developing in different market segments or asset classes and to prevent parts of the Union's securitisation market from closing down in times of crisis, EBA, in close cooperation with ESRB, shall develop draft regulatory technical standards within six months of the date of publication of such a report and develop revised regulatory technical standards every two years thereafter, in order to specify:~~

~~(a) — the level retention rate referred to in Article 4(1) within a maximum range from 5% to 20%, applicable for modalities of retention listed in Article 4(2), taking into account the specificities of market segments;~~

~~(b) — to what extent guarantees are applicable on the securitised assets;~~

~~(c) — whether the originator has retained the exposures on its balance sheet for part of their original maturity, when setting the required retention rate;~~

~~(d) — whether the required retention rates shall be brought up to the maximum of 20% or motivate why it should be adjusted downward, while taking into account specificities of market segments; and~~

~~(e) — if guarantees are applicable on the securitised assets.~~

~~Those draft regulatory technical standards shall be developed by ... [two years from the date of entry into force of this Regulation] or, as the case may be, two years from the time the most recent draft regulatory technical standards were developed pursuant to this paragraph. An adjustment of the retention rate included in the draft regulatory technical standards will come into effect for securitisations that have not been notified to the ECB in accordance with Articles 243 and 244 of Regulation (EU) No 575/2013 by the time of the entry into force of those regulatory technical standards.~~

~~EBA shall submit those draft regulatory technical standards to the Commission by ... [two years from the date of entry into force of this Regulation].~~

~~The Commission is empowered to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1093/2010.~~

4. — ~~Whenever a draft RTS is submitted under paragraph 2 of this Article, the Commission shall also consider whether, in accordance with Article 270f (new) of Regulation (EU) No 575/2013, amendments to the risk floor levels for securitisations in Articles 259, 260, 261, 263 and 264 of Regulation (EU)~~

~~No 575/2013 on prudential requirements for credit institutions and investment firms are required, and adopt delegated acts accordingly, where appropriate.~~

3. Fines for cherry-picking/adverse selection

The introduction of a possibility to impose fines can be considered for incidents of cherry-picking of assets by originators. It is however paramount that **the intent of wrongdoing** (i.e. the fact that adverse selection has taken place) is prohibited and not the fact that the performances of securitised and non-securitised assets differ, even significantly, because this event could be due to random factors beyond the originator's control. For the same reason, sanctioning should not be automatic but the supervisor should have sufficient discretion to properly take into account the specific circumstances of each case.

It is also important that sanctions are **imposed on the originator**, since it is the originator who selects the assets to be securitised. The original lenders and/or sponsor cannot be held responsible for a selection they did not perform.

Finally, it is important to **avoid introducing reporting requirements** on the performance of securitised and non-securitised assets for all originators. Such requirements would impose a considerable, possibly prohibitive, additional burden on small and/or non-financial issuers.

Drafting proposal for lines 135, 149, 155-156 (based on the ECON text)

Article 4

Risk retention

- 1a. **Originators shall not select assets to be transferred to the SSPE with the aim of rendering losses on the securitised assets transferred to the SSPE, measured over one year the life of the transaction, shall not be significantly higher than the losses over the same period on homogenous assets, following Article 8 (4) of this Regulation, held on which are randomly selected from the balance sheet of the originator or the original lender of a securitisation. In the case the competent authority finds evidence suggesting contravention of this prohibition, condition is not met, the competent authority shall investigate the performance of assets transferred to the SSPE and homogeneous assets held on the balance sheet of the originator. investigate potential adverse selection of assets by the originator, sponsor or the original lender of a securitisation, If the performance of the transferred assets is significantly lower than that of the homogenous assets held on the balance sheet of the originator as a consequence of the intent of the originator, the competent authority shall impose a fine following Article 17 of this Regulation.**
6. The European Banking Authority (EBA), in close cooperation with the European Securities and Market Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) shall develop draft regulatory technical standards to ~~amend the level of risk retention according to article 16a (new) of this~~

~~**Regulation and**~~ specify in greater detail the risk retention requirement, in particular with regards to:

[(a) the modalities of retaining risk pursuant to paragraph 2, and the minimum retention rate of a first loss exposure pursuant to point (e) of paragraph 2;]

[(b) the measurement of the level of retention referred to in paragraph 1;]

[(c) the prohibition of hedging or selling the retained interest;]

[(d) the conditions for retention on a consolidated basis in accordance with paragraph 3;]

[(e) the conditions for exempting transactions based on a clear, transparent and accessible index referred to in paragraph 5;]

~~**(ea) — the annual reporting duties of the originator, sponsor or the original lender of a securitisation to supervisors on the losses suffered on securitised assets in comparison to the retained assets, needed to assess the obligation of paragraph 1a;**~~

~~**(eb) — the procedure to randomly select homogenous assets from the balance sheet of the originator or original lender, the measurement used to determine whether a difference in losses is significant and how to calculate the benefit derived from this infringement according to paragraph 1a.**~~

4. Ensure the definition of originator is not abused to circumvent the risk retention requirements

The definition of originator introduced in the STS regulation is taken from CRR article 2.3(b). Under this definition, an entity buying loans from a 3rd party qualifies as an originator and can therefore retain the mandated risk level. There is evidence that some entities are abusing this definition to effectively circumvent the risk retention requirements. For this reason, the Commission had included in its proposal a provision that prevents entities established with the sole purpose of securitising exposure (e.g. SSPEs) from qualifying as originators. This is because, having only minimal capital requirements, these entities cannot effectively retain risk, since any losses generated by the pool of underlying assets would be borne *de facto* by the holders of the securitisation notes. Hence, such entities should not be able to qualify as originators.

This provision has been eliminated in the ECON proposal, thus allowing entities taking advantage of this to issue securitisation with virtually no risk retention. Since this runs counter to the aim of ensuring "skin in the game" shared by the European Parliament and Council, this important provision should be reinserted.

Drafting proposal for line 134 (based on the ECON text please note that the Commission services argue for the deletion of the part in square brackets)

Article 4

Risk retention

1. The originator, sponsor or the original lender of a securitisation shall retain on an ongoing basis a material net economic interest in the securitisation of not less than 5 % *[for 10 % depending on the retention modality chosen in accordance with paragraph 2. As part of the mandate given pursuant to Article 16a of this Regulation, the European Banking Authority (EBA) in close cooperation with the ESRB shall take a reasoned decision on required retention rates of up to 20 % in light of market circumstances. The material net economic interest shall be measured at the time of origination and shall be determined by the notional value for off-balance sheet items]*. Where the originator, sponsor or the original lender have not agreed between them who will retain the material net economic interest, the originator shall retain the material net economic interest. There shall be no multiple applications of the retention requirements for any given securitisation. The material net economic interest shall be measured at the origination and shall be determined by the notional value for off-balance sheet items. The material net economic interest shall not be split amongst different types of retainers and not be subject to any credit risk mitigation or hedging.

For the purposes of this Article, an entity shall not be considered to be an originator where the entity has been established or operates for the sole purpose of securitising exposures.

ANNEX I – Arguments to maintain the current risk retention levels

In addition to the strong and wide consensus on the adequacy of the current risk retention regime, the analysis below concludes that the proposed increase in risk retention levels is unnecessary, ineffective and damaging.

- a) **It is unnecessary** because there is no sign of misalignment of interest between originators and investors in EU securitisation: if there were misalignment, the performance of EU securitisation could not have been as strong as it was during the deepest financial crisis since 1929, with losses equal to 0.2% of assets for residential mortgage securitisation (biggest part of the market) compared with 8.6% in the US. The worst performing EU securitisations generated 4% losses vs. 28.2% in the US. EU securitisation has been proven to be an asset class *safer than several corporate and sovereign bonds during the crisis*.

What's more, there is no evidence that EU originators select the worse assets for securitisation while keeping the best assets on their balance sheet. There is actually evidence of the opposite: *EU originators tend to select the best assets for securitisations*, in order to signal to markets that there is no cherry picking and assuage their fears. This has been shown clearly by two recently published papers by the ECB and the Bank for International Settlements (BIS)⁵.

- b) **It is ineffective** because there is *no evidence that higher risk retention levels for vertical methods would increase the alignment of interest* between the originator and investors. As explained in annex 2 (see below), no retention method is superior or ensures a better alignment of interests for securitisation than all other methods in all cases. Accordingly, making retention levels dependent on the retention method is not justified. This point is made clearly also by a study published by the BIS⁶.
- c) **It is damaging** because *it will increase substantially the cost of issuing securitisations and it will reduce the possibility to achieve significant risk transfer, deconsolidation and capital relief*, which is the main purpose for securitising assets.

We understand that roughly 40% of outstanding EU ABS deals use vertical methods and that short-term securitisation (ABCP) predominantly uses vertical methods. Should the risk retention levels for vertical methods rise to 10%, the capital needed to issue these securitisations would double. It is important to notice that, while big banks may be able to sustain this increase - since they typically do not securitise 95% of their assets and have ample capital pools - smaller players will suffer the most. These smaller players tend to have small balance sheets and to securitise most of them. The doubling of retention levels may make these issuers' business model unsustainable. These are local banks, consumer credit lenders, CLO managers and other issuers that provide credit to firms and households and have proven to be safe during the crisis. The EP proposal would effectively put them at a disadvantage with big banks.

By increasing the cost of using vertical methods and thus fostering the use of horizontal methods, higher retention levels for vertical methods will also hinder the achievement of

⁵ See: "Securitisation and credit quality", ECB working paper n. 2009, February 2017 and "Asymmetric information and the securitisation of SME loans" BIS working paper n.601, January 2017.

⁶ See: "The future of securitisation: how to align interests?" BIS quarterly review, September 2009.

Significant Risk Transfer (SRT). Lower risk securitisations (such as mortgage securitisations representing 2/3 of the EU market) will find it particularly hard to achieve SRT and accounting deconsolidation. Thus, the EP proposal would introduce a big disadvantage also for low risk-low return securitisations funding European housing credit.

ANNEX II – The Krahnen-Wilde (SAFE) paper and why no retention method is superior or ensures better alignment of interests than another in all cases.

To incentivize originators to control the quality of securitised assets, Retained Losses (RL) must increase with the Total Losses generated by the securitised assets (TL). In other words, $\frac{\partial RL}{\partial TL}$ must always be positive. This proportion determines the amount of "skin in the game".

In contrast, Krahnen and Wilde define the amount of "skin in the game" as the portion of the total losses retained by the originator, or $\frac{RL}{TL}$. This leads them to conclude that risk retention methods with higher $\frac{RL}{TL}$ (i.e. the horizontal method) ensure more "skin in the game".

In reality, however, neither of the two approaches (horizontal vs. vertical) is superior in terms of providing better incentives for the control of the quality of assets. In fact, the two methods' effectiveness depends on the expected level of total losses. Below we will prove why.

Under the horizontal method, the originator retains all losses until the total losses reach the minimum required retention level (i.e. $\frac{\partial RL}{\partial TL} = 1$ for $TL \leq 5\%$). Above that level, the originator does not retain any losses (i.e. $\frac{\partial RL}{\partial TL} = 0$ for $TL > 5\%$). Thus, if losses are expected to exceed 5%, under the horizontal risk retention model, the originator has no incentive to control the quality of assets.

In contrast, under the vertical method, the originator retains losses in proportion to the losses generated *irrespective of the level of TL* (i.e. $\frac{\partial RL}{\partial TL} = 5\%$ for any TL). Under this approach, therefore, the originator always has an incentive to control the quality of assets.

Therefore, for securitisations with low expected TL, the horizontal method may be more effective, while for securitisations with high expected TL, the vertical method may be more effective. It follows that neither of the two methods always ensures better alignment of interests than another method. Accordingly, making retention levels dependent on the retention method is not justified.