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EU Directive Introduces a 5 per cent Risk Retention Requirement

The Swedish Capital Adequacy and Large Exposures Act (Sw. Lag (2006:1371) om kapitaltäckning och stora exponeringar) has been amended as part of the implementation of the Capital Requirement Directive (2009/111/EC) (CRD II). The Swedish Financial Supervisory Authority (Sw. Finansinspektionen) (SFSA) has also issued detailed regulations (FFFS 2007:1) (as amended) implementing CRD II.

This New Alert focuses on the newly introduced 5 per cent risk retention rules and due diligence requirements that apply to securitization transactions. The reform aims to address some of the shortcomings revealed by the financial crisis and future excessive risk taking by aligning the interests of the originator or sponsor with the interests of the investor.

Risk Retention

CRD II tightens the regulations on exposures to securitization transactions by introducing a requirement of 5 per cent originator risk retention. This means that a credit institution, other than an originator, sponsor or original lender, may only take on exposures to the credit risk of a securitization position if the originator, sponsor or original lender has explicitly disclosed that it will retain, on an ongoing basis, a material net economic interest of not less than 5 per cent. Article 122a of CRD II provides that retention of the "net economic interest" means any of the following:

- retention of no less than 5 per cent of the nominal value of each of the tranches sold or transferred to the investors;
- in the case of securitizations of revolving exposures, retention of the originator's interest of no less than 5 per cent of the nominal value of the securitized exposures;
- retention of randomly selected exposures, equivalent to no less than 5 per cent of the nominal amount of the securitized exposures, where such exposures would otherwise have been included in the securitization, provided that the number of potentially securitized exposures is no less than 100 at origination; or

- retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total no less than 5 per cent of the nominal value of the securitized exposures.

The term "ongoing basis" means that the retained positions, interest or exposures cannot be hedged or sold. "Net economic interest" is determined by the notional value for off-balance sheet items. The regulation provides some flexibility in that the minimum retention requirement can be fulfilled in any of the four ways described above. It cannot, however, be fulfilled by two or more parties acting jointly, neither by combining one or more of the retention options.

Due Diligence, Stress Tests and Monitoring

Investor due diligence, stress tests and monitoring procedures of the underlying exposures of securitization positions are also part of the new legal framework. The due diligence requirement means that an investing credit institution must be able to show the SFSA that it has a comprehensive and thorough understanding of the securitization positions, the underlying exposures and risks related to them. Detailed data on, for example, the seniority of a tranch, cash flows and historical developments of similar tranches, must be accessible in relation to the position an investor plans to invest in. In order to improve the quality of its analysis and due diligence, credit institutions are required to keep written internal guidelines and instructions for this purpose. Stress tests developed by external parties may only be used if the credit institution can show that it has carefully assessed and evaluated these tools before investing in them. Monitoring must be done yearly and in accordance with certain standards set out in regulations issued by the SFSA.

"Same Criteria" and Disclosure Requirements

Further requirements are imposed on credit institutions when acting as sponsors or originators. They are required to apply the same criteria in respect of credits given to exposures that will be securitized as they apply to exposures that are held on their books. They are also required to apply the same analysis to participations or underwritings in securitization issues purchased from third parties regardless if such participations or underwritings are held on their trading or non-trading book. A disclosure requirement is introduced which require credit institutions to disclose the level of their retention commitment to investors. They shall also ensure that investors have access to all materially relevant data on the credit quality and performance of the underlying exposures, cash flows and collateral supporting the securitization, as well as such information that is necessary to conduct comprehensive and well informed stress tests.

Exemptions

Certain exposures are exempt from the 5 per cent retention requirement. Exemptions apply to securitization exposures benefiting from guarantees given by central governments or central banks, regional governments, local authorities and public sector entities within the EU, multilateral development banks and certain institutions which are considered to be counterparties with a low risk. Another exemption apply to transactions based on a clear, transparent and accessible index, such as CDX and Itraxx. Syndicated loans, purchased receivables and credit default swaps that are not used to package or hedge a securitization are also carved out.

More to Come

The amendments to the existing legislation came into effect on 30 June 2011. With that, the remainder of CRD II has been implemented in Sweden. A second set of amendments, based on the third CRD (2010/76/EU) (CRD III), will come into effect on 31 December 2011. A fourth CRD (CRD IV) is also being proposed by the European Commission.

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