

ClientAlert

Financial Markets Developments

Securitization
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EU versus US approach to reform of the Securitization Market

On June 17, 2009, President Barack Obama proposed a plan to overhaul regulation of the United States financial services industry (the "Obama Plan"). Included in the plan are proposals to reform the securitization market, but there are many political and legal hurdles that stand in the way of those proposals becoming law. In contrast, reforms in the European Union are further down the legislative track. The EU approach was adopted by the European Parliament on May 6, 2009, via Article 122a of the Capital Requirements Directive (the "EU Directive").¹

While the EU approach is further along and, as a result, more detailed than the proposed Obama Plan, it is nevertheless informative to note some of the similarities and differences that exist between the proposed US and EU initiatives.

Summary of the US and EU Securitization Initiatives

Skin in the game

One of the key provisions in both the EU and US initiatives is a requirement that originators and sponsors retain a five percent interest in a securitization. Beyond this superficial similarity, however, the initiatives differ as to which parties bear the burden of ensuring that the five percent risk retention is satisfied. In the Obama Plan, it appears that sponsors and/or originators will be responsible for ensuring that transactions meet the five-percent retention requirement, while the EU Directive places the onus on the investor. In other words, the Obama Plan applies to all securitizations regardless of who is purchasing, but the EU approach only requires retention when the investor is an EU credit institution.²

Article 122a(1) states that "A credit institution...shall only be exposed to the credit risk of a securitization position...if the originator or sponsor...**has explicitly disclosed to the credit institution** that it will retain a material net economic interest of not less than five percent."³

Article 122a(4) states that credit institutions⁴ that are investors must have "implemented



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¹ Article 122a(8) provides that Article 122a will become effective for new securitizations from December 31, 2010 and shall apply for existing securitizations from December 31, 2014. In addition, Article 122a will also need to be ratified by the European Council, published and formally adopted by each EU member state. On May 6, 2009 the European Parliament also adopted a number of other amendments to the Capital Requirements Directive which are outside the scope of this paper.

² However, it should be noted that the EU is currently contemplating legislation to the effect that insurance companies and hedge funds would not be able to invest in securitizations unless the five percent requirement is met.

³ Emphasis added.

⁴ A "credit institution" is defined in the EU Directive. In essence it is "an undertaking whose business is to receive deposits or other repayable funds from the public."

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formal policies and procedures” to verify a number of matters including the disclosure of the retention requirement by the originator/sponsor. If the obligations of the credit institution “are not met in any material respect by reason of the negligence or omission **of the credit institution**,”⁵ Article 122a(5) provides that a regulator may adjust the risk weighting of the investment. This is not to say that under the EU approach originators and sponsors do not also have obligations—see, for example, Article 122a(6). At the very least, however, the emphasis of the EU Directive is more “holistic”—i.e., all parties need to take responsibility for understanding the nature of the transactions that they enter into; the requirement goes beyond ensuring that the right level of information is available.

It is also worth noting that the EU Directive will apply to all investments in securitizations by EU credit institutions. For example, a purely US deal (i.e., one that involves US assets, US law and with US transaction parties) would be required to satisfy the EU Directive if the transaction’s securities are to be sold to an EU credit institution.

Calculation of the five-percent stake

The requirement in Article 122a(1) is for retention of a “material net economic interest” which “shall mean” one of four specified alternatives. While the retention requirement in each case is “at least” five percent, there is no consideration in Article 122a itself that other ways of achieving the material net economic interest can be contemplated. In the Obama Plan, “federal banking agencies” are given authority to specify permissible forms of risk retention. Potentially, the US approach may lend itself to more flexibility on this point, as regulators may conceivably be able to revisit and refine any such definitions.

Both the US and the EU are quite clear that a retained economic interest may not be hedged or otherwise transferred. Article 122a states that the retained interest must be maintained on an “on-going basis.” This phrase is defined to mean that the retention requirement cannot be “hedged or sold.” Presumably, it also means “for the life of the transaction.” However, the Obama Plan specifically provides that regulators may specify the “minimum duration of the required risk retention,” suggesting once again that, at this stage, the US regulators contemplate some flexibility on the point. Finally, it should be noted that in the US proposal, regulators would be given flexibility to raise or lower the five percent threshold and provide exemptions to the “no hedging” requirement. In the EU Directive, the exceptions to the retention requirements are hard wired into Article 122a(2).

⁵ Emphasis added.

⁶ See the “second call” for advice from the Commission to the Committee of European Banking Supervisors dated June 12, 2009.

In Article 135 of the EU Directive, the EU Commission is required to report by the end of 2009 on the expected impact of Article 122a. Article 135 itself states that the report should consider in particular whether Article 122a helps to better align the interests of originators, sponsors and investors, strengthen financial stability “and whether, an increase of the minimum retention requirement would be appropriate.” So, while the EU Directive contemplates that the retention requirement may be increased, it does not currently consider that it could be lowered. It is possible that the EU Commission could use the report to consider some other issues noted here and by other commentators, but given the line of questions posed by the Commission to the Committee of European Banking Supervisors, it would appear that they are less concerned about a lack of flexibility than closing off any potential “loopholes.”⁶

Originators and sponsors

Both the Obama Plan and the EU Directive state that the retention requirement needs to be satisfied by “originators” or “sponsors.” For most types of “standard” securitizations (e.g., RMBS, credit card, consumer loans, etc.) this retention requirement is intuitive; the sponsors and/or originators are the people who know most about the underlying assets. To ensure an alignment of interests, those parties should be made to retain an economic stake in the deal. Awkwardly, however, this retention requirement does not fully take into account securitizations in which the underlying assets are purchased from the general market rather than being originated by a particular bank (i.e., an arbitrage CLO). In such deals, it is not that clear who would or even could be either an originator or a sponsor. The person who is generally considered to best understand the underlying assets is, in fact, the collateral manager, but in the EU Directive, it seems unlikely that they would fall within either of the definitions of originator or sponsor. Intriguingly, the Obama Plan contemplates the ability to apply the retention requirements “to sponsors (in order to achieve the appropriate alignment of incentives).” It would be helpful if ultimately the definition of sponsor in the US provides more flexibility than the EU Directive.

Due diligence

The Obama Plan calls for the continued improvement and standardization of disclosure practices to ensure that investors and rating agencies have access to the right quality of information. It is submitted that there is, in fact, a considerable difference between ensuring that the right sort of information is published and making that, at least in part, the responsibility of the investors. A key feature of Article 122a is the obligation on investor EU credit institutions to demonstrate that they have a thorough understanding of the risks and the detail of the transactions.

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Article 122a(4) enumerates a number of different aspects of a securitization that need to be analyzed and requires that this be done prior to investing and as appropriate thereafter. Article 122a(5) requires that those institutions establish “formal procedures... to monitor on an ongoing basis and in a timely manner performance information on their securitization positions.” Failure to satisfy these requirements would lead to an increased risk weighting as discussed above.

Compensation

The Obama Plan states that “the compensation of brokers, originators, sponsors, underwriters, and others involved in the securitization process should be linked to the longer-term performance of the securitized assets, rather than only to the production, creation or inception of those products.” The Obama Plan states that this type of approach should also apply to fees and commissions received by loan brokers and loan officers who otherwise have no ongoing relationship with the loans they generate.

Historically, broker/dealers that underwrite or place the securities offered in connection with a securitization generally receive their fees on the date that the securities are sold. These parties may find it unattractive to have their fees deferred and ultimately linked to the performance of the securitized assets. A deferral of fees is particularly unattractive to entities that are required to report earnings publicly each quarter. Some institutions may determine to exit the business of underwriting and placing US securitizations. This could lead to significantly less liquidity in the US securitization market.

At the time of writing, this feature does not exist in the EU Directive; it is conceivable that this will change in future amendments.

Conclusion

Over the coming months the Obama Plan will make its way through the US legislative and regulatory process and the concepts contained in the plan will become laws, rules and regulations. In addition, it is anticipated that there will be numerous further regulatory initiatives published by a number of national and supranational authorities. It is, for example, currently contemplated that there will be two further amendments to the Capital Requirements Directive this year—clearly some of those could have further bearing on Article 122a. Given the international nature of securitization, an obvious concern to all market participants is the potential inconsistencies that may develop from these overlapping regulatory reforms. Even at this preliminary stage, it would appear that we are witnessing a difference of approach and emphasis between the EU and the US that could be material for the securitization market in future years. Securitization market participants will need to consider the myriad of rules that will apply in cross-border transactions and transactions seeking a global investor base.

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