Originator risk retention in securitisation

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The subprime crisis triggered a debate on whether the originate-to-distribute model of banking was responsible for abdication of credit discipline by banks, and whether banks were originating junk loans only because they could offload them. Ideologically, the debate could have no meaning. If banks would originate good loans only if they were to hold the same to themselves, a shoemaker would stitch good shoes only if he were to wear them all himself. However, regulators all over the world have gone into a frenzy enacting regulatory rules mandating originator risk retention in securitisation transactions.

A new phrase, particularly in European regulatory parlance, seems to have come up: misalignment of incentives. Essentially, this means the incentives of the originator and those of the investors are different. Supposedly, the originators are interested in pushing down poor quality loans, which do not suit the interests of the investors.

EU regulations:

One of the early such regulatory requirements was the resolution by the EU Parliament, on May 5, 2009, inserting Art 122a in the Capital Requirements Directive. Art 122a did not apply to originators – it applied to European credit institutions investing in securitisation transaction. The reason why this regulation was applied to investors may be two fold – one, several of the securitisation transactions may be jurisdictionally domiciled in offshore jurisdictions, where EU may not have its sway, and two, in Europe, the immediate concern was more from viewpoint of European banks having burnt money investing in US transactions. Hence, the focus was investment-oriented, not much disciplining European originators. As for originators, the only requirement is in Para 6 of Art 122a – that originators will maintain the same credit standards for their securitized exposures as they maintain in case of self-retained exposures.

The regulation debarred a European credit institution from investing in any such transaction unless the originator was exposed at least to the extent of 5 percent to the "net economic interest" on an ongoing basis. To elaborate, Art 122a requires originators to retain either of these: (a) minimum 5 % of all the securitized tranches sold to investors; (b) retention of randomly selected exposures, where there are at least 100 such exposures being securitized, such that the value of the retained exposures is at least 5% of total; or (c) retention of first loss piece being at least 5% of the net economic interest.

These requirements are applicable to securitisation transactions, which involve pooling or packaging of receivables. The requirements are not applicable to a cash or synthetic transfer of a single loan. That is to say, a bank may sell the whole of a loan to another bank. A bank may synthetically transfer the whole of a loan to another bank by entering into a credit default swap. However, if the originating bank bundles several loans together, the requirements get attracted.

Questions remain whether the requirements are applicable to following situations:

(a) **A repackaging transaction**: For example, Bank A transfers the whole of a loan to Bank B. Bank B acquires several such exposures from different banks, and now repackages these exposures into a securitisation transaction. The idea of originator risk retention was to insist on the originating institution retaining exposure. Bank B is not the originator – so, is Bank B required to retain minimum risk mandated by Art 122a? The CEBS report (quoted in the next section) recommended clear exclusion of transactions where the underlying motive is not risk transfer but funding. Multi-seller transactions have been recommended for exclusion.
(b) As the requirements are related to "securitisation", how exactly does one define a securitisation? For example, if an originator transfers several loans on a single loan basis to a special purpose vehicle, and the latter issues a bond, is that a case of securitisation?

Besides minimum risk retention, Art 122a requires investing institutions to assure regulators that they have understood the risk characteristics of the underlying assets, reputation of the originator/sponsor, disclosures made, etc. Investing institutions must apply their own stress tests to see the robustness of the transaction.

If investing institutions violate these conditions, they are punished by applying risk weights of 250% for the first violation, progressively increasing in case of continuing ones.

Four options of risk retention:

The EU regulation provides for 3 options of risk retention. A fourth option was proposed by CEBS report, discussed below. The 3 options are as follows:

(a) 5% vertical piece: The first option under the EU regulation is retention of 5% of the all the tranches. This may be called the vertical 5% risk. Assuming a securitisation of $ 100 million is split into 4 tranches (Class A $ 85 million, Class B $ 5 million, Class C $ 5 million, and Class D $ 5 million), the originator holds 5% of each of the 4 classes. This is the same as the originator holding 5% of the entire pool, or having a pari passu 5% seller's share in the total pool. Note that a pari passu 5% seller's share is not the same thing as over-collateralisation of the pool by 5%, as the over-collateralisation amounts to a subordinated interest. However, the vertical risk slice is not subordinated, but parallel interest in the pool.
(b) 5% horizontal piece: The retention of a first loss piece of 5% implies retention of a horizontal, bottom piece in risk of the transaction. As in the example above, the originator would hold the whole of Class D in the transaction. It is clear that there is a huge difference between holding a vertical slice and a horizontal slice. In case losses eat 3% of the assets in the pool, in case of vertical risk, the originator would lose only 5% of the 3% loss, as the remaining 95% of Class D is with

external investors. In case of horizontal piece, the originator would absorb 100% of the loss.

(c) Holding back loans worth at least 5%: This is a crude form of over-collateralisation. Over-collateralisation, strictly speaking, creates a subordinated interest of the seller to the extent the Over-collateralisation. However, holding pack identified loans, amounting to at least 5%, would expose the originator to losses only if such loans go bad. This is not a form of credit support at all. Of all forms of risk retention, this is the least subservient to the purpose of originator risk.

(d) The fourth option is so-called L-shaped risk slice. The interesting name suggests that the originator holds some part of the first loss piece, which may not be 5%, and in addition holds a vertical slice too.

Surprisingly enough, the CEBS report on adequacy or equivalence of the forms of credit support (cited below) has recommended the vertical slice, which, according to it, ensures originator risk from "cradle to grave", that is, until the last of the loans has been paid. The observation is based on the misnotion that the performance of loans would worsen if originators do not have a continuing exposure on the loans. In fact, the horizontal 5% piece amounts to 100% exposure to the extent of the first loss piece – hence, the originator's skin in the game is far more than in case of vertical slice. Credit risk is more relevant at the point of origination; subsequently, the loan only has to be properly serviced. But if at origination, a loan is bad, however effective servicing cannot make it good.

CEBS report on supervisory practices:

As a part of art 122a, EU parliament had asked of advice of the the Committee of European Banking Supervisors (CEBS) to report on whether art 122a would meet the purpose for which it was intended, and whether supervisory practices in respective EU jurisdictions matched with the requirement of the EU parliament.

On 30th Oct 2009, the CEBS submitted its advice on the effective of minimum originator risk retention requirements[1]. The Report spent quite a bit of space justifying why, according to it, the vertical form of credit support more appropriately met the requirement of originator's continuing involvement right from the beginning of the transaction to its end.

In addition, the report recommended what it called the L-shaped risk piece. The L-shaped slice is a combination of the first loss piece and pari passu interest, that is, horizontal and vertical share put together. For example, if the regulations require a 2% first loss piece, and 4% pari passu interest, the originator holds at least 2% of the first losses, and has a continuing involvement on account of the pari passu interest. According to the Committee, the L-shaped support marries the advantages of the horizontal and the vertical piece.

[1] http://www.c-ebs.org/documents/Publications/Advice/2009/article-122a/Advice.aspx

US rule making proposals

In the USA, several legislative proposals have been mooted mandating a minimum risk retention in the hands of originators. Directly on the issue on credit risk retention is a bill called HR 1731: Credit Risk Retention Act, 2009[2]. This Bill also proposes a minimum risk retention of 5 percent in all securitisation transactions. Several other Bills, such as HR 4173 (sponsored by Barney Frank) called Wall Street Reform and Consumer Protection Act 2009), Restoring American Financial Stability Act of 2010 (Dodd Bill), etc also propose minimum originator risk retention of 5%.

In April 2010, the SEC came up with a 667-page proposal to amend Reg AB pertaining to asset backed securities. Apart from many new requirements for disclosures, the proposed rules require a minimum risk retention in all shelf-offered asset backed securities.

The US SEC proposal requires only 5% vertical piece. As we have discussed above, the horizontal 5 percent piece would have anyway been much more painful for originators; hence most originators would elect to have a vertical 5 per cent slice. This is what the SEC is mandating.

In conclusion, the market is searching for appropriate answer for originator risk retention. The present regulatory proposals are only reactive, as if rule-making is an answer to a problem that resulted not from absence of rules, but from overdose of exuberance.

[2] http://www.govtrack.us/congress/bill.xpd?bill=h111-1731