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Update

Momentum

Banking and Finance

THE «SKIN IN THE GAME» SOLUTION: ASSESSING THE RETENTION REQUIREMENT IN SECURITISATIONS

The recent capital markets turmoil has put securitisation at the centre of the debate. Awareness of the flaws of asset-backed securities – poor screening of borrowers, loose eligibility criteria, excessively complex structures, insufficient disclosure, unbalanced risk dissemination - has caused a significant deterioration in *investor appetite* and led to a depressed securitisation market; spreads are high and liquidity is scarce.

However, albeit this sudden collapse of the market, securitisation is still regarded as crucial for financial firms. Its potential to ensure balance-sheet management and capital relief, disseminate systemic risk and provide cheap financing (which may hopefully trickle-down) remains a strong reason for banks, regulators and governments to push for the necessary reforms. What is at stake is thus not how to shut-down the securitisation market, but how to revive it in a sustainable fashion.

With this purpose the proposed amendments to the Capital Requirements Directive (CRD), still pending approval but likely to be in place in the first trimester of 2010, provide for the implementation of the so called *retention requirement*. In short, the future article 122A CRD will prevent EU credit institutions from purchasing asset-backed securities except if the originator, sponsor or original lender has *retained, on an ongoing basis, a material net economic interest of no less than 5%*. This retention requirement can be met in different ways: retention of a portion of each tranche (*vertical slice*) or of the equity/first-loss tranche; in revolving structures, retention of an interest in the overall securitised exposures; or retention of non-securitised equivalent exposures.

The aim is clear: to avoid misalignment of incentives between originator and investors. By making it mandatory that originators retain a not insignificant amount of underlying risk, they will suffer the negative consequences of inadequate credit screening, underwriting practices and servicing. *The originator retains some skin in the game, and hence a direct incentive for prudent behaviour*. This is pursued indirectly, by preventing banks from purchasing asset-backed securities when the originator does not retain a portion of the risk. In this way, also transactions by non-EU originators become ineligible for investment by EU banks if lacking this risk-sharing element.

True, other regulatory measures can help attain this fundamental goal: that is the case of rules calling for simpler structures, increased transparency and improved ratings. Also, market-based safeguards such as reputation and client relationships may enhance alignment of incentives. They will not, however, be enough; not in the current situation, when restoring trust in the market is of the essence.

The retention requirement thus seems a positive development. First, it is actually not imposing a completely new practice, as EU originators have already been retaining, at least on closing, some risk in securitisations (common also in the Portuguese market). Second, the 5% threshold seems adequate, as it imposes relevant risk-bearing without necessarily hindering the cost of the structure. Finally, the proposal seem flexible enough, providing different ways to achieve the desired risk-sharing.

Tough times call for clear measures; and that is precisely what the proposed changes to the CRD seem to be aiming at. Hopefully, they will succeed.

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