

MEMORANDUM

To: EBA
Re: EBA risk retention consultation paper (EBA/CP/2013/14)
By: Gordian Knot
Date: August 2013

This memo is written in response to the EBA consultation on draft regulatory technical standards for risk retention in securitisations. As an investor in securitisations, we support initiatives by regulators and originators which promote risk retention and the alignment of interest between issuers and investors, and welcome the opportunity to comment.

We recognise that the amount of risk retained and the methods of retention are set in Article 405 of the Capital Requirements Regulation (CRR). However, we view this regulation as a missed opportunity to enforce a market-based method for risk retention based on the form of retention that best aligns interest across the capital structure, i.e. the vertical slice.

Risk retention in the form of a first loss piece allows the issuer to receive cash flows that may reduce their economic interest in the deal, and may encourage the issuer to bias the risk-return profile of the underlying asset pool to increase returns to junior noteholders. In contrast, the vertical slice method of risk retention ensures that the issuer considers the interests and returns of all tranches issued by a securitisation.

We do not support an arbitrary amount of risk retention, for example the 5% set out in the CRR. This amount will be wrong at least as many times as it is right. Instead we would propose that the amount of risk retained is agreed by all investors at the time of syndication, specific to each securitisation.

Much like the setting of tranche pricing, the syndication process is well equipped to resolve the differing interests and requirements of investors across the capital structure. For example, if investors bidding for the most senior tranche request 5% retention while the more junior tranches require, say, 15% retention the returns and retention will be adjusted during the syndication process until the market clears at a level of retention between 5% and 15%.

The result of such a market setting mechanism is that new deals issued by less experienced issuers may require higher levels of risk retention to 'clear' at syndication, whereas a securitisation issued by an established and respected issuer may require a lower level of risk retention as a result of greater investor confidence garnered from their proven track record. Regulators may then monitor the outcome of this process over time and decide if the market-based solution is sufficient for them.

When viewed in collaboration with the Return Allocated Capital Equivalence approach for securitisation capital requirements (see <http://www.bis.org/publ/bcbs236/gordian.pdf>), vertical slice retention using a market-derived retention amount ensures that all interests are truly aligned. The originating bank would also maintain the same percentage capital requirement on the retained securitised amount as it would have if it held the exposure in unsecuritised form.

The benefits of this approach are that the process is transparent and market-based and the interests of the issuer are fully aligned with all investors.