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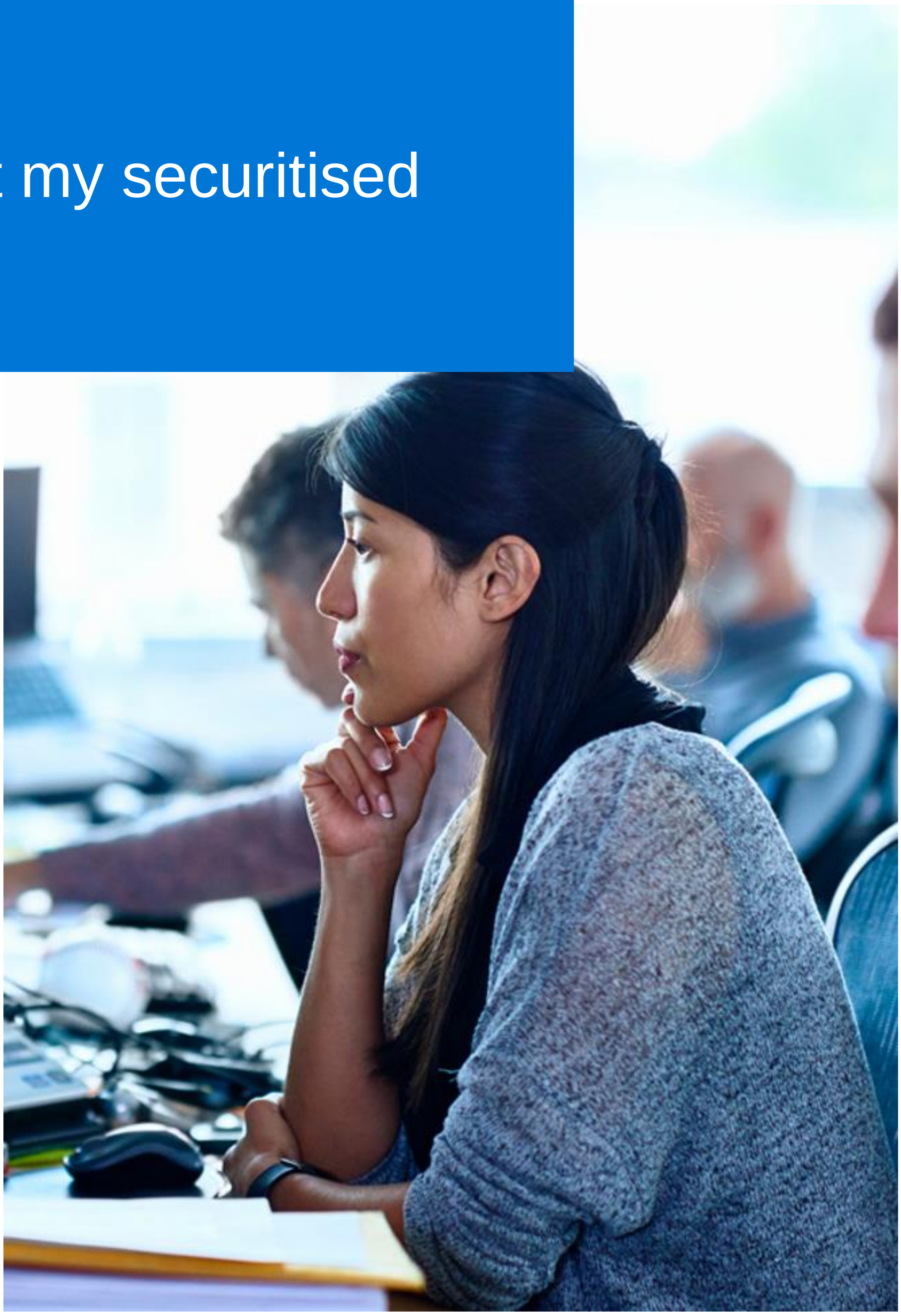
# EU risk retention rules

## Do they affect my securitised investment?



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## Introduction

There is a common misconception that UK and European-based investors are constrained from holding US securitised bonds due to the EU risk retention rules. This is not the case. EU and UK investors can purchase US securitised bonds as long as the issuers of these bonds comply with the EU risk retention rules. This means that US issuers of securitised bonds need to retain at least 5% of the credit risk to be eligible for European investors.

UK and European investors believe that the 5% retention rule is an onerous directive for issuers of US securitised bonds and that it may significantly reduce the size of the investment universe. However, the reality is that EU securitised rules are similar to the requirements under the Dodd-Frank Act, in which the 5% retention rule is commonplace.

## Background

EU risk retention rules and the Dodd-Frank Act share a common background, primarily rooted in the 2008 global financial crisis (GFC). Both sets of regulations were introduced as a response to the GFC to enhance market stability and align interests between securitisation participants. The GFC highlighted several significant deficiencies in the securitisation rules such as lax underwriting standards, misaligned incentives between originators and investors and lack of transparency about the underlying assets. This led to led to widespread reforms in both jurisdictions.

The primary goal of both regulations is to reduce moral hazard and improve the quality of securitised assets by ensuring that originators and sponsors maintain a stake in the performance of the assets they securitise. This helps to prevent the securitisation of poorly underwritten loans.

## Alignment of regulations

Both the EU and US regulations aim to align the interests of originators, sponsors, and investors by requiring a retention of at least 5% of the credit risk. This is intended to ensure that those who create and sell securitised products have ‘skin in the game’. Under the Dodd-Frank Act, the 5% risk retention rule applies to a wide range of securitised bonds. Below we have listed those, as well as some notable exceptions.

In addition, both frameworks allow for various forms of risk retention, such as vertical and horizontal risk retention, or a combination of both. This flexibility helps to accommodate different types of securitisation structures.

### Table 1 – Which types of US securitised bonds does the Dodd-Frank Act 5% rule apply to?

| Type | Description | 5% risk retention rule applies |
|---|---|---|
| RMBS | Residential mortgage-backed securities: backed by residential mortgages. | Yes |
| CMBS | Commercial mortgage-backed securities: backed by commercial real estate loans. | Yes |
| CLOs (middle market) | Collateralised loan obligations: backed by a pool of loans, typically leveraged loans originated by the CLO manager. | Yes |
| Credit cards | Credit card receivables: backed by credit card debt. | Yes |
| Auto loans | Auto loan and lease securitisations: backed by auto loans and leases. | Yes |
| ABCP | Asset-backed commercial paper: short-term securities backed by various types of assets, including trade receivables and other short-term debt. | Yes |
| Other | Other consumer and commercial loans: this includes a variety of other consumer and commercial loan-backed securities. | Yes |
| RMBS guaranteed by the GSEs | Securities issued or guaranteed by government-sponsored enterprises (GSEs): this includes entities like Fannie Mae and Freddie Mac. | Exempt |
| CLOs (broadly syndicated loans) | Collateralised loan obligations: backed by a pool of loans, typically leveraged loans purchased in the secondary market. | Exempt |
| QRMs | Qualified residential mortgages: residential mortgages that meet specific underwriting standards designed to ensure high credit quality. | Exempt |
| Student loans | Federally guaranteed student loans: certain student loans that are guaranteed by the federal government. | Exempt |
| Seasoned loans | Loans that have been outstanding and performing for a specified period (typically two years) before being securitised. | Exempt |

Source: LGIM, November 2024

## What are the challenges?

While there are many similarities – the overarching goals of enhancing market stability, transparency, and investor protection – there are some nuances to be aware of between the rules.

Under the EU risk retention rules, the 5% risk retention must be held by the issuer and/or originator, whereas in the US, the 5% risk retention can be transferred to a third party, though the issuer/originator remains accountable if the third-party breaches the risk retention regulations. At L&G we adopt a conservative approach by only investing in transactions where the 5% risk retention is retained by the issuer/originator so our holdings more closely align with the EU regulations.

For CLOs (collateralised loan obligations), there are distinctions between broadly syndicated loans (BSL) and middle market (MM) CLOs. BSL CLOs in the US are exempt from the 5% risk retention rule because CLO managers purchase loans in the secondary market rather than originating them. This exemption was confirmed by the US Court of Appeals in 2018. However, MM CLOs must comply with risk retention as these loans are originated by CLO managers. At L&G, for both BSL and MM CLOs, we seek offering documents that indicate that the manager retains a 5% interest, again as this more closely aligns with EU regulations.

Some US issuers have adapted to the EU rules and requirements to access the EU investor base. Others have chosen to avoid the additional compliance costs and complexities. While this reduces the size of the eligible universe, it does not present any meaningful diversification[1] challenges given the immense size of the US market.

EU investors also are required to conduct due diligence to ensure that the securitised products they invest in meet the EU's transparency and disclosure standards. This can be a barrier if any US issuers do not provide the necessary information to meet these standards. However, for any seasoned investor conducting in depth due diligence research on the security and underlying assets, this does not present a meaningful obstacle.

## Summary

Both regulations collectively (EU risk retention and Dodd-Frank) aim to create a more resilient and trustworthy securitisation market, ultimately contributing to financial stability. While there are additional compliance and disclosure requirements for US issuers, this typically does not present a meaningful challenge for UK and European-based investors to purchase these bonds.

## Securitised strategies at Legal & General Asset Management

Our dedicated team of securitised specialists is committed to selecting assets for both the US Securitised Fund and the US Securitised Plus Fund. Securitised assets are also integral to our Buy & Maintain portfolios, available in both pooled and segregated formats, catering to institutional investors such as pension schemes and insurers.

[1] **It should be noted that diversification is no guarantee against a loss in a declining market.**

## Key Risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested. Past performance is not a guide to future performance.

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