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POSTMASTER: Send address changes to THE BANKING LAW JOURNAL LexisNexis Matthew Bender, 121 Chanlon Road, North Building, New Providence, NJ 07974.

EU Risk Retention Requirement: Who Can Now Retain in a Managed CLO?

NICK SHIREN AND ROBERT CANNON

The authors explore the implications for collateralized loan obligations of the risk retention requirement in the European Union's Capital Requirements Regulation.

Article 405 of Regulation (EU) No 575/2013 (the "Capital Requirements Regulation") imposes on European Economic Area ("EEA") credit institutions and investment firms investing in securitisations issued on or after January 1, 2011, or in securitisations issued prior to that date where new assets are added or substituted after December 31, 2014, the requirement that each such institution:

> …other than when acting as an originator, a sponsor or original lender, shall be exposed to the credit risk of a securitisation position in its trading book or non-trading book only if the originator, sponsor or original lender has explicitly disclosed to the institution that it will retain, on an ongoing basis, a material net economic interest which, in any event, shall not be less than 5%.

Nick Shiren is a partner in the Capital Markets Department of Cadwalader, Wickersham & Taft LLP, where his practice focuses on complex financing transactions involving a wide variety of asset classes. Robert Cannon is an associate in the firm's Capital Markets Department. The authors, resident in the firm's office in London, can be reached at nick.shiren@cwt.com and robert.cannon@cwt.com, respectively.

The requirement applies broadly to "securitisation" positions.[1] National regulators in EEA member states impose penal risk weights on securitisation investments in respect of which the requirement in Article 405 has not been satisfied in any material respect by reason of the negligence or omission of the investing credit institution or investment firm.

A requirement similar to the requirement in Article 405: (i) applies to investments in securitisations by investment funds managed by EEA investment managers subject to EU Directive 2011/61/EU; and (ii) subject to the adoption of certain secondary legislation, will apply to investments in securitisations by EEA insurance and reinsurance undertakings and by EEA undertakings for collective investment in transferable securities.

The retention requirement is not satisfied by an entity committing to retain a five percent net economic interest unless such entity is an original lender, originator or sponsor in relation to the relevant securitisation. The most significant issue for collateral managers and arrangers structuring collateralized loan obligations ("CLOs") that are to satisfy the EU risk retention requirement is to identify an entity that is involved in the transaction and that is an original lender, an originator or a sponsor.

ORIGINAL LENDER, ORIGINATOR, SPONSOR

"Original lender" is not defined in the Capital Requirements Regulation but is taken to mean the original lender or other obligee under the underlying asset.

"Originator" is defined[2] as either (i) an entity that itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised or (ii) an entity that purchases a third party's exposures for its own account and then securitises them.

"Sponsor" is defined[3] as an institution[4] other than an originator institution that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third-party entities.

APPLICATION TO CLOs

It is difficult to identify an entity involved in a CLO which will come within any of the definitions of original lender, originator and sponsor. This is because:

- The loans that are the underlying assets of managed CLO transactions are generally acquired in secondary market sales from a diverse group of sellers who have no involvement with the CLO. Neither the original lenders under the loans, nor the sellers from whom the loans are acquired (such sellers being within the definition of "originator") commit to retain five percent of the loans that they originate/sell. Such original lenders and sellers have no interest in giving such a commitment. In any case, it would be impractical to try to obtain such a commitment in respect of each loan in the CLO, as for each different loan the relevant original lender or seller would need to give the commitment.
- The definition of "sponsor" is limited to credit institutions and certain entities subject to the requirements of MiFID, thereby excluding certain categories of collateral managers including the typical US collateral manager.

REGULATORY GUIDANCE SO FAR

The Committee of European Banking Supervisors ("CEBS") (as it was then known) published "Guidelines to Article 122a of the Capital Requirements Directive" (the "Guidelines") on December 31, 2010[5] and the European Banking Authority ("EBA") published a Q&A document (the "Q&As")[6] on September 29, 2011, both of which provided useful guidance to the application of the risk retention requirement to a number of specific transaction types including managed CLOs (Article 122a being the predecessor to Article 405 of the Capital Requirements Regulation). However, the Guidelines and Q&A are largely to be replaced by secondary legislation, termed "regulatory technical standards" ("RTS"), to be issued under Article 410(2) of the Capital Requirements Regulation.

FINAL DRAFT RTS

Following a period of consultation,[7] the EBA published its final draft RTS (the "Final Draft RTS") on December 17, 2013.[8] The key objectives of the Final Draft RTS are two-fold: (i) creating an alignment of interest (risk) and information between securitisation sponsors, originators, original lenders and investors buying securitisation transactions; and (ii) facilitating the implementation of the five percent retention and disclosure requirements of the sponsor, originator or original lender and the due diligence requirements of investors in securitisations. The Final Draft RTS differ from the Guidelines and the Q&As and have a number of significant consequences for determining who may retain in a managed CLO.[9]

An involved subordinated investor cannot retain; collateral managers may retain as "sponsors" but only if subject to the requirements of MiFID

Paragraphs 25 and 26 of the Guidelines recognised that in certain limited circumstances it is not possible to identify any party to a transaction that fits any of the roles of "original lender," "originator," or "sponsor" and that in such circumstances, it should be ensured that there is retention by "whatever party would most appropriately fulfil this role outside of the specific constraints of these definitions" including an "asset manager of a securitisation where there is on-going management and substitution of exposures (where such asset manager is not a credit institution), or the most subordinated investor in a securitisation where such investor was also involved in structuring the transaction and selecting the exposures to be securitised (but is by definition neither the originator nor the sponsor, and nor is it the original lender)."

The Final Draft RTS provide that the retention must be fulfilled in full by the originator, the sponsor or the original lender[10] (with no exceptions). This rules out the possibility that an involved subordinated investor may satisfy the retention requirement.

The expanded definition of "sponsor" in the Capital Requirements Regulation[11] leaves open the possibility that the collateral manager may satisfy the retention requirement provided that it is subject to the requirements of MiFID. However, a collateral manager that is not subject to the requirements of MiFID, such as a US collateral manager, cannot be an "investment firm" and therefore cannot be the retainer on this basis. Indeed, in response to questions raised during the consultation period, the EBA notes that "a wider definition exceeds the notion of sponsor enshrined in the Capital Requirements Regulation, which does not make any reference to recognised third country institutions and applies only to institutions covered by the Capital Requirements Regulation." The difficulty for the EBA in extending the definition of "sponsor" so that it can include non-EEA entities carrying on investment firm activities is that the definitions of "sponsor" and "investment firm" are contained within the Capital Requirements Regulation itself and would require amendment to the level 1 text.

Retention by the parent/affiliate of the "sponsor" collateral manager is ruled out

Paragraph 2 of Article 122a allows the retention requirement to be met by looking at the situation of each institution included within the scope of supervision on a consolidated basis. Paragraph 2 is limited to: (i) groups including an EU credit institution or an EU financial holding company and (ii) securitisations where more than one entity within the group is an originator or original lender.

The Guidelines recognise that the ability to fulfil the requirements of Article 122a on a consolidated basis should also apply to originators or original lenders other than credit institutions.[12] That is, entities that may be consolidated for accounting purposes but not for supervisory purposes. Q&A 21 also provides that as long as the parent/affiliate of the collateral manager is consolidated at group level the retention requirement can be met by the parent/affiliate.

The Final Draft RTS refer to retention on a consolidated basis only in the circumstances provided for in paragraph 2 of Article 405 of the Capital Requirements Regulation and do not contain any provisions equivalent to those of paragraphs 71 of the Guidelines and Q&A 21. Although the EBA recognises that in order to achieve alignment of interest it is not essential that consolidation be accomplished in accordance with the applicable accounting framework or with regard to the scope of supervision on a consolidated basis, or that exposures from one or several credit institutions, investment firms or other financial institutions be securitised, it notes that allowing retention on a consolidated basis in accordance with the applicable accounting framework would not be in line with the level 1 text.

Additional clarity is provided in the case of retention by a sponsor where there are multiple sponsors

Paragraph 29 of the Guidelines provides that in circumstances where the securitised exposures are those of multiple originators or original lenders, then retention of the net economic interest must be fulfilled by each original lender or originator with reference to the proportion of total securitised exposures in the securitisation for which it is the originator or original lender — the requirement cannot be undertaken by one originator or original lender retaining a net economic interest while none of the other multiple originators or original lenders retain any net economic interest.

Q&A 16 went beyond paragraph 29 of the Guidelines and gave flexibility by providing that an originator/sponsor can satisfy the retention requirement as long as this originator/sponsor has provided "the majority" of the portfolio in the securitisation transaction and is involved in structuring the transaction, selecting the initial portfolio and defining the eligibility criteria and tests.

Following feedback received by the EBA during the consultation period, the Final Draft RTS do contain a similar concession that where there are multiple originators or original lenders the retention may be fulfilled in full by a single originator or original lender provided that: (i) the originator or original lender has established and is managing the programme or securitisation scheme (Article 4(2)(i)); or (ii) the originator or original lender has established the programme or securitisation scheme and has contributed over 50 percent of the total securitised exposures (Article 4(2)(ii)). The Final Draft RTS also provide additional clarity in circumstances where there are multiple sponsors by providing that the retention shall be fulfilled by: (i) the sponsor whose economic interest is most appropriately aligned with investors or (ii) each sponsor pro rata in relation to the number of sponsors.

A possible solution for US collateral managers?

By allowing a single originator that has established and is managing the securitisation to satisfy the retention requirement, the concession contained in Article 4(2) of the Final Draft RTS allows the retention requirement to be met by any entity that would meet the definition of sponsor except for the fact that it is not an "institution" (for example, it is a US collateral manager which typically is not a MiFID investment firm with the necessary authorisations), provided such entity originated some of the loans.

How many loans?

A strict reading of the Final Draft RTS leads to the conclusion that, so long as the originator has established and is managing the programme or securitisation scheme, it is sufficient that the originator is the originator of a single loan sold to the CLO. If the originator had originated more than 50 percent of the loans then it would be within Article 4(2)(ii) in any case, so it is clear that an originator that has originated less than 50 percent of the loans can come within Article 4(2)(i) and there is nothing in Article 4(2) or the Final Draft RTS more generally to suggest that origination of any more than a single loan is required to come within Article 4(2)(i).

What if the single loan originated by the originator defaults, redeems or is sold?

The Final Draft RTS states that the retention requirement shall not be deemed to have been affected by the amortisation of the retention via cash flow allocation or through the allocation of losses, which, in effect, reduce the level of retention over time.[13] Therefore, a default or redemption of the loan originated by an originator of a single loan that comes within Article 4(2)(i) should not result in the retention requirement ceasing to be satisfied. However, where such a loan is sold by the CLO it may be considered that the originator has ceased to be an originator of any loan in the CLO with the result that the retention requirement ceases to be satisfied. Until guidance is received from the EBA on this point a collateral manager retaining on the basis of Article 4(2)(i) should ensure that at all times during the life of the CLO at least one loan then held by the CLO has been acquired from the collateral manager and that the collateral manager had previously held the loan for its own account.

What if the collateral manager is replaced following a resignation or removal?

A replacement collateral manager will not be an originator unless and until it has held a loan for its own account and sells such loan to the CLO. Provision could be made in the transaction documents for such an arrangement to occur as part of a replacement of a collateral manager. However, the wording of Article 4(2)(i) provides that the originator must have established and be managing the programme or securitisation scheme. An issue therefore arises as to whether a replacement manager can be said to have "established" the CLO when it has had no involvement with it. In relation to this, we note that the requirement that the originator have established and be managing the CLO also applies where the retention is by a collateral manager that meets the definition of sponsor (for example, the collateral manager is a MiFID investment firm with the necessary authorisations). In such case, until guidance is given by the EBA, it is uncertain whether and, if so, how, the retention requirement will be satisfied on a replacement of the collateral manager. However, this issue has not stopped CLOs closing with retention by a collateral manager that meets the definition of sponsor.

The collateral manager will need to comply with certain restrictions under the Investment Advisers Act of 1940

The collateral manager of any CLO using these proposed retention structures will need to be ready to address questions of compliance with the Investment Advisers Act of 1940 (the "Advisers Act"). Section 206(3) of the Advisers Act prohibits certain transactions between investment adviser (the collateral manager in this case) and/or its affiliates and other managed accounts, on one hand, and the client of the investment adviser (the CLO) on the other. In the case of an originator which is another client of the collateral manager, the sale of assets from such originator to the CLO will be a client cross-trade and both entities must evidence their consent (which may be a prospective, blanket consent) to the trades. In the case of an originator which is an affiliate of the collateral manager or if the collateral manager itself is to be the originator, then each sale of assets from such originator to the CLO will be a principal trade and the CLO must evidence its consent to each such transaction and may not give a prospective or blanket consent. In many cases, since the board of directors of a CLO is typically not experienced in such matters, the CLO will appoint an independent review panel and empower it with the authority to act on the CLO's behalf in reviewing and consenting to (or rejecting) each such trade.

NEXT STEPS

In response to a request that transactions entered into in good faith between 2011 and 2013 that are in line with the requirements of the Guidelines and Q&A be grandfathered from the new rules contained in the Final Draft RTS, the EBA noted that any such grandfathering would result in a derogation of the objective scope of application of the new Capital Requirements Regulation securitisation regime, which is an essential element of the level 1 legislation. However, the Guidelines and Q&A will remain relevant to a competent authority's decision when assessing whether an additional risk weight should be applied in cases where there is a material breach of the Capital Requirements Regulation.

The Final Draft RTS have been sent to the European Commission for their adoption as EU regulations that will be directly applicable throughout the EU.

NOTES

[1] "Securitisation" in this context is: a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having the following characteristics: (i) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and (ii) the subordination of tranches determines the distribution of losses during the on-going life of the transaction or scheme.

[2] Article 4(1)(13) of the Capital Requirements Regulation.

[3] Article 4(1)(14) of the Capital Requirements Regulation.

[4] "Institution" is defined as a credit institution or an investment firm: Article 4(1)(3) of the Capital Requirements Regulation. "Investment firm" is limited to those entities that are subject to the requirements imposed by the EU Markets in Financial Instruments Directive (Directive 2004/39/EC) ("**MiFID**") and which are neither (i) local firms nor (ii) firms (A) which are not authorised to provide the service of

safekeeping and administration of financial instruments for the account of clients, (B) which provide only one or more of the investment services of reception and transmission of orders in relation to one or more financial instruments, execution of orders on behalf of clients, portfolio management and investment advice, and (C) which are not permitted to hold money or securities belonging to their clients and which for that reason may not at any time place themselves in debt with those clients. Article 4(1)(2) of the Capital Requirements Regulation.

[5] http://www.eba.europa.eu/documents/10180/106202/Guidelines.pdf.

[6] http://www.eba.europa.eu/documents/10180/16325/EBA-BS-2011-126-rev1QA-on-guidelines-Artt122a.pdf.

[7] http://www.eba.europa.eu/documents/10180/209701/EBA-BS-2013-091rev2--RTS-ITS-securitisation-retention-rules-clean.pdf.

[8] http://www.eba.europa.eu/documents/10180/529248/EBA-RTS-2013-12+and+EBA-ITS-2013-08+%28Securitisation+Retention+Rules%29.pdf.

[9] Indeed, paragraph 23 of Section 4.2 of the accompanying documents notes that "the approach taken to transpose the provisions of the CEBS Guidelines on retention requirements into the draft RTS is likely to impact materially on the functioning of specific securitisation classes and on the compliance features of the (subdued) number of transactions currently being structured/carried out within those market segments."

[10] Article 4(1) of the Final Draft RTS.

[11] In the Capital Requirements Regulation "sponsor" is: an institution other than an originator institution that establishes and manages an…other securitisation scheme that purchases exposures from third party entities; "institution" is: a credit institution or investment firm; and "investment firms" are institutions as defined in Article 4(1)(1) of Directive 2004/39/EC (MiFID) which are subject to the requirements imposed by that Directive, excluding the following: (i) credit institutions; (ii) local firms; and (iii) firms which are only authorised to provide the service of investment advice or receive and transmit orders from investors without holding money or securities belonging to their clients and which for that reason may not at any time place themselves in debt with those clients.

[12] Paragraph 71 of the Guidelines.

[13] Article 11(1)(e) of the Final Draft RTS.