Clients&FriendsMemo

European Banking Authority Publishes Final Draft Regulatory Technical Standards on Securitisation Retention Rules – Who Can Now Retain in a Managed CLO?

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I. Introduction

Earlier this week, the EBA published its final draft Regulatory Technical Standards ("**Draft RTS**") on securitisation retention rules and related requirements[1]. The RTS are intended to provide greater clarity and transparency for market participants, and to support compliance and foster convergence in supervisory practices across the European Union ("**EU**").

The key objectives of the 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 5% retention and disclosure requirements of the sponsor, originator or original lender and the due diligence requirements of investors in securitisations.

II. Summary

- An involved subordinated investor cannot retain
- Collateral managers may retain but only if subject to the requirements of MiFID
- Retention by the parent/affiliate of the "sponsor" collateral manager is ruled out
- Additional clarity is provided in the case of retention by a sponsor where there are multiple sponsors

[1] http://www.eba.europa.eu/-/eba-publishes-final-draft-technical-standards-on-securitisation-retention-rules

- No grandfathering for transactions entered into between 2011 and 2013, although 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 CRR

III. Background

Directive 2009/111/EC ("**CRD 2**")[2] incorporated Article 122a into the Capital Requirements Directive[3]. Article 122a provides in part:

"*A credit 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 credit institution that it will retain, on an on-going basis, a material net economic interest which, in any event, shall not be less than 5%.*"

Wide scope

The requirements of Article 122a apply broadly to "securitisation" positions[4]. Although CRD 2 applies only to credit institutions, there is other EU legislation that applies or will apply the requirement for a 5% risk retention to investments in securitisations by investment firms, insurers and reinsurers[5], UCITS[6], and alternative investment funds[7] managed by an alternative investment fund manager that is subject to the Alternative Investment Fund Managers Directive.

No grandfathering after 1 January 2011

The cut-off date for grandfathering of securitisations is the same for all of the risk retention requirements for all types of regulated investors, i.e. only securitisations issued *prior* to 1 January 2011 are grandfathered and such grandfathered

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2 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF

3 Capital Requirements Directive (or "**CRD**") is an expression which refers to Directive 2006/48/EC and Directive 2006/49/EC as amended

4 "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: (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and (b) the subordination of tranches determines the distribution of losses during the on-going life of the transaction or scheme

5 Article 135 of Directive 2009/138/EC ("**Solvency II**"). It is expected that Solvency II will come into force on 1 January 2016 at the earliest

6 Article 50a of Directive 2009/65/EC ("**UCITS IV**"), inserted by Article 63 of 2011/61/EU ("**AIFMD**"). The European Commission regulation to be adopted under Article 50a has not yet been published

7 Article 17 of AIFMD and Articles 50 – 56 of Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012

securitisations lose the benefit of the grandfathering if at any point on or after 1 January 2015 new underlying assets are added to the securitisation.

Regulatory guidance so far

In the context of a managed CLO, there have been difficulties in identifying the "originator, sponsor or original lender" to satisfy the risk retention requirement because of the definitions of those terms contained in CRD 2[8]. However, 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 31 December 2010[9] and the EBA published a Q&A document (the "**Q&As**")[10] on 29 September 2011, both of which provided useful guidance to the application of the risk retention requirements to a number of specific transaction types including managed CLOs.

The legislation to implement the Basel III standards includes the Capital Requirements Regulation ("**CRR**")[11] which lays down prudential requirements for capital, liquidity and the credit risk for investment firms and credit institutions in EU member states. The CRR, together with the proposed CRD IV Directive, is referred to as "CRD IV" and will recast and replace the CRD. It will apply going forward from 1 January 2014. The CRR replaces Article 122a with Articles 404 to 410 of the CRR. Articles 404 to 410 differ in some respects from Article 122a, and, in addition to applying to credit institutions, will apply to investment firms.

Once finalised, the Draft RTS will replace the Guidelines and Q&A. The Draft RTS provide that the Guidelines and Q&A will remain relevant to a competent authority's decision only when assessing: (a) whether an additional risk weight should be applied in cases where there is a material breach of Articles 405, 406, or 409 CRR by reason of the negligence or omission of an institution and where the respective securitisation position is part of a transaction issued on or after 1 January 2011 and before 1 January 2014, and (b) how to interpret substitution of exposures for transactions before 1 January 2011 as referred in Article 404 CRR.

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[8] In particular, (a) "originator": loans comprising the portfolio will have been sold to the CLO from a number of different lenders; (b) "sponsor": it is unlikely that the arranging bank will be a "sponsor" as it will not be an entity that "establishes ***and manages*** [a] … securitisation scheme", and it is unlikely that the collateral manager will be a "sponsor" as it typically will not be a credit institution; and (c) "original lender": there will be numerous "original lenders" in respect of the loans comprising the portfolio

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

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

[11] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:EN:PDF

IV. The final draft Regulatory Technical Standards

Following a period of consultation[12], the EBA published the Draft RTS pursuant to Article 410(2) of the CRR. The 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[13].

An involved subordinated investor cannot retain; collateral managers may retain 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 Draft RTS provide that the retention must be fulfilled in full by either the originator, the sponsor or the original lender[14] (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 CRR[15] 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 asset manager, cannot be an "investment firm" and therefore cannot be the retainer. Indeed, in response to questions raised during the consultation period, the EBA notes that "a wider definition exceeds the notion of

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

[13] 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 materially impact on the functioning of specific securitisation classes and on the compliance features of the (subdued) number of transactions currently being structured/carried out with in those market segments"

[14] Article 4(1) of the Draft RTS

[15] In the CRR "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: (a) credit institutions; (b) local firms; and (c) 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

sponsor enshrined in the CRR, which does not make any reference to recognised third country institutions and applies only to institutions covered by the CRR". 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 CRR 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: (a) groups including an EU credit institution or an EU financial holding company and (b) 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[16]. 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 Draft RTS refer to retention on a consolidated basis only in the circumstances provided for in paragraph 2 of Article 405 of the CRR 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

[16] Paragraph 71 of the Guidelines

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 further 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 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; or (ii) the originator or original lender has established the programme or securitisation scheme and has contributed over 50% of the total securitised exposures. The 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.

V. Where to next?

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 Draft RTS, the EBA noted that any such grandfathering would result in a derogation of the objective scope of application of the new CRR 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 CRR.

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

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Please feel free to contact any of the following Cadwalader lawyers if you have any questions about this Clients & Friends Memo.

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