Clients&FriendsMemo

EU Risk Retention Requirement: A workable solution for US CLO collateral managers?

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Background

Article 405 of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (the "**Capital Requirements Regulation**") imposes on European Economic Area ("**EEA**") credit institutions and investment firms investing in securitisations issued on or after 1 January 2011, or in securitisations issued prior to that date where new assets are added or substituted after 31 December 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%.*

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 5% net economic interest unless such entity is an original lender, originator or sponsor in relation to the relevant securitisation. The most significant issue for US collateral managers and arrangers structuring 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 lender or other obligee under the underlying asset.

"Originator" is defined as[1] 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 as[2] an institution[3] 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 US CLOs

It is difficult to identify an entity involved in a US 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 5% 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 the typical US collateral manager.

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

2 Article 4(1)(14) of the Capital Requirements Regulation.

3 "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.

May 2013 Consultation Paper

Article 410(2) of the Capital Requirements Regulation provides for secondary legislation, termed "regulatory technical standards" ("**RTS**"), to be issued to specify in greater detail the retention requirement. On 22 May 2013, the European Banking Authority ("**EBA**") issued a consultation paper (the "**Consultation Paper**")[4] in relation to draft RTS.

The Consultation Paper followed paragraph 29 of the guidelines on Article 122a (the predecessor to Article 405 of the Capital Requirements Regulation)[5] that stated that where there are multiple originators of the securitised exposures, in order to satisfy the retention requirement, the retention must be fulfilled by each originator in relation to the proportion of the total securitised exposures for which it is the originator.

Following the publication of the Consultation Paper, the retention on CLOs that were to satisfy the EU retention requirement was effected in one of two ways:

- Retention by an EEA-regulated investment manager that has the authorisations necessary for it be a sponsor. (In some cases EEA-regulated investment managers extended their authorisations in order to come within the definition of sponsor.)
- Retention by an originator entity through which the CLO acquired the loans[6]. This originator entity not only sold to the CLO the loans contained in the CLO's initial portfolio, but also sold to the CLO all other "post-closing" loans including both during and after the reinvestment period. This would require the originator entity to first acquire each such loan and then, after holding such loan for a sufficient period to be regarded as having held such loan "for its own account" (in accordance with the definition of "originator"), to sell such loan to the CLO.

  The difficulty with this "originator entity" structure is that reinvestment by the CLO is dependent upon the co-operation of the originator entity in originating the loans. If a loan were to be acquired other than from the originator entity, then the seller of that loan would constitute a second originator and would need to hold a share of the retention in order that the retention be fulfilled by each originator in relation to the proportion of the total securitised exposures for which it is the originator.

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

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

[6] The CLO should also confirm that the acquisition of a loan from the originator complies with any US tax guidelines to which the CLO is subject.

Final Draft RTS

Following the Consultation Paper, the EBA published its final draft RTS (the "**Final Draft RTS**") on 17 December 2013[7].

The Final Draft RTS introduces a significant new concession by providing in Article 4(2) that the retention may be fulfilled in full by a single originator provided that either:

(i) such originator has established and is managing the programme or securitisation scheme (Article 4(2)(i)); or

(ii) such originator has established the programme or securitisation scheme and has contributed over 50% of the total securitised exposures (Article 4(2)(ii)).

This concession allows for the satisfaction of the retention requirement by having either of the following entities hold the retention:

- the collateral manager where it has itself acquired some of the loans and then, after a period of holding them for its own account, sold them to the CLO. As the collateral manager "has established and is managing the [...] securitisation" it can satisfy the retention requirement provided it is the originator of some of the loans.
- an originator entity which "has established the [...] securitisation" and through which the CLO acquired the loans. This originator entity need not originate all of the loans or be involved in the management of the CLO, provided that at any time during the life of the CLO more than 50% of the loans have been originated by the originator entity.

By allowing a single originator that has established and is managing the securitisation to satisfy the retention requirement, Article 4(2) 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% 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% 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).

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

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[8]. 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 we suggest that 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

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

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

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.

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