41 CLOs and the Securitisation Regulations

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Introduction

CLOs play a hugely important role in the European corporate credit market. These products draw in investments from a broad pool of asset managers, pension funds, insurance companies and other institutional investors and apply those investments towards the purchase of corporate loans and bonds, either in the primary market as part of an original syndication, or in the secondary market, by way of trading to purchase such assets from an existing holder.

CLOs make up a significant portion of investments in sub-investment grade corporate debt. As a result, investors in CLOs and funds, as well as their managers, have a large influence on the direction of the European leveraged loan market, at times impacting loan documentation on a market wide basis. The regulation of these products is therefore of great significance to the loan market. Furthermore, the inexorable link between the end investors, fund managers and regulation of such products helps to explain both existing developments of, and liquidity to, the loan market, but also future challenges and developments that may result from the implementation of and compliance with such regulation.

CLOs continue to be subject to a raft of regulatory requirements, the most comprehensive of which are those contained in Regulation (EU) 2017/2402 (the 'EU Securitisation Regulation') and such EU Regulation in the form in effect on 31 December 2020, which forms part of UK domestic law by virtue of the European Union (Withdrawal) Act 2018, as amended by the Securitisation (Amendment) (EU Exit) Regulations 2019 of the United Kingdom (the 'UK Securitisation Regulation' together the 'Securitisation Regulations').

This chapter will therefore focus on the application of the Securitisation Regulations to CLOs structured as securitisations and the impact of such regulation on the underlying loans in which CLOs invest.

Application of Securitisation Regulations to CLOs

The Securitisation Regulations apply to CLOs where the originator, sponsor or original lender of a CLO is located in the EU or the UK. The regulations also restrict EU and UK 'institutional investors' from investing in CLOs that do not comply with the applicable Securitisation Regulation.

Transactions fall within the Securitisation Regulations on the basis of the structure subordinating tranches of debt, and payments on those tranches being dependent on the performance of the underlying assets. The premise of a CLO is to allow investors to select from a number of available tranches representing differing levels of risk and associated interest rates, with payments in respect of such tranche being dependent on the performance of the underlying loans in which the CLO invests. Hence CLOs, while not necessarily a traditional 'asset-backed security' product, fall within the definition of a securitisation for the purposes of the Securitisation Regulations.

The genesis of the EU Securitisation Regulation was the desire to harmonise and bring together three previously existing 'indirect' regulatory requirements to investors that are: (1) banks under the CRR; (2) insurance providers under the Solvency II regime; and (3) certain fund managers under the Alternative Investment Fund Managers Directive regime. In addition it now applies requirements directly to securitisation SPV sponsors and originators of securitisations.

The requirements applicable to EU and UK securitisations cover both indirect investor and direct sell-side perspective requirements relating to:

- risk retention;
- transparency; and
- credit-granting.

This chapter will seek to briefly describe these requirements, highlight their current and, in some cases future, impact on the loan and loan funding markets, and to inform on any divergence of such requirements between the EU Securitisation Regulation and the UK Securitisation Regulation.

STS Transactions

The Securitisation Regulations also put in place a new framework for simple, transparent and standardised (STS) securitisations, which provide certain credit institutions and investment firms with preferential regulatory capital treatment (i.e., a lesser amount of cash or high quality assets to be held against the securitisation position). Despite the efforts of market participants and the LMA, CLOs do not qualify for the STS label and the details of the related criteria are therefore not set out in this chapter.

Risk Retention

The risk retention requirements set out at Article 6 of the Securitisation Regulations apply to any originator, sponsor or original lender of a CLO, provided such party is located within the EU or the UK (as applicable). In addition, Article 5(d) of the Securitisation Regulations requires that EU and UK 'institutional investors' undertake diligence to ensure that the relevant retainer in the CLO retains a net economic interest in the securitisation, as required under the Securitisation Regulations.

The sponsor, originator or original lender of a CLO must hold a material net economic interest of not less than 5% in respect of a CLO. Further:

- A ‘sponsor’ is a credit institution as defined in point (1) of Article 4(1) of the CRR, or an investment firm as defined in point (1) of Article 4(1) of Directive 2014/65/EU other than an originator, that: (1) establishes the CLO; and (2) either manages or delegates the day-to-day active portfolio management to an authorised entity.

- An ‘originator’ is an entity which either: (1) was involved in the original agreement creating certain of the underlying loans; or (2) purchased certain of the underlying loans 'on its own account' and then securitises them (through the CLO). Unless the originator is also managing the transaction, it will need to have originated at least 50% of the underlying loans. A manager originator in the CLO context will usually originate 5% of the underlying loans. An originator cannot also operate for the 'sole purpose' of securitising exposures for securitisations.
- An ‘original lender’ is an entity which concluded the original agreement which created the underlying loans, similar to limb (1) of the originator definition above.

For CLOs where none of the originator, sponsor or original lender are located in the EU, accessing the European CLO market via the sponsor route remains uncertain and such managers typically hold retention as originators, in many cases having to take some form of credit risk over a portion of the portfolio of loans, thereby falling within the definition of ‘originator’ above. The LMA alerted the European Commission and European regulators to this ambiguity, but the issue remains an open point.

Under the UK Securitisation Regulation, however, the definition of ‘sponsor’ has been amended and seeks to address the ambiguity under the EU Securitisation Regulation, so where there are no EU investors, a retention holding manager of a CLO may be a sponsor, located in any country without having undertaken origination for the vehicle. It is unlikely however that a CLO investor base would not contain (or that the noteholders in the CLO would not want the flexibility to sell to) EU investors and so currently, due to the ambiguity under the EU Securitisation Regulation, the sponsor route is unlikely to be taken by UK managers of CLOs.

There are a number of options for retaining risk in securitisation transactions, but for CLOs it is typically held as either a 'vertical' interest or a 'horizontal/first loss' interest.

Over the years, from the inception of the risk retention under the CRR through to the current iterations of the Securitisation Regulations, the LMA has been at the forefront of participating in consultations and numerous meetings with the European Commission, the European regulators and Members of European Parliament regarding the practical issues around all aspects of the Securitisation Regulations. In particular, the LMA was involved in the extensive negotiations regarding the more troubling provisions of the EU Securitisation Regulation during the early consultation phase.

One such provision was the proposal by Members of European Parliament to increase the amount of risk retention required to 20%. This would have been catastrophic for the CLO market, as that level of risk retention would have been a barrier to all but the largest CLO managers.

Transparency

Article 7 of the Securitisation Regulations provide that the originator, sponsor and the SPV of a securitisation must make certain information relating to the securitisation available to investors, competent authorities (i.e., national regulators) and, upon request, to potential investors.

The requirements include provisions relating to:

- disclosure of transaction documentation;
- quarterly asset and payment date reporting; and
- reporting of inside information and significant events for the securitisation and periodic reporting of information on the underlying assets of the securitisation and investor reporting.

In particular, the quarterly reporting on the underlying assets of CLOs require extensive and detailed information in respect of all loans included in a CLO.

Article 5 of the Securitisation Regulations also requires certain European and UK investors to verify that prior to investing in the securitisation, parties to securitisations have agreed to make this information available. Under the EU Securitisation Regulation, the diligence requirements require that investors receive the information 'in accordance with the frequency and modalities required' under Article 7.

In regards to CLOs where none of the originator, sponsor, original lender or SPV are located within the EU, it is currently unclear whether EU investors must receive the same information as they would if one of those parties was located in the EU. This has been a significant ambiguity in the EU Securitisation Regulation, which has caused issues for EU institutional investors investing in non-EU CLOs. The European regulators have provided their views to the European Commission as to how this ambiguity should be resolved. It is expected that this issue will be addressed in the recast of the EU Securitisation Regulation expected in 2021.

On the other hand, the UK Securitisation Regulation clarifies this position by requiring specific template reporting only where the SPV, sponsor, originator or original lender is located in the UK, and otherwise to verify that the information to be received is itself 'substantially the same' as would have been provided had that entity been established in the UK. This has removed some uncertainty for UK investors. However, it is unclear as to what would constitute 'substantially similar'.

During the consultation, it became clear that certain aspects of the reporting templates would be problematic to complete, due, in large part, to the fact that the underlying assets in a CLO are typically broadly syndicated corporate loans. For example, some of the information required could only be provided by an entity that was involved in the initial underwriting process of the loan. At various stages throughout the consultation process, the LMA was able to convince ESMA to make changes to the reporting templates that contemplate broadly syndicated leveraged loans.

The reporting templates are broad in scope, and while publicly traded CLOs have always provided reports to investors in respect of the assets in CLOs, the detailed scope of the reporting under the transparency requirements and the requirement to make such reporting available to 'potential investors', in particular in public CLOs, means that there is more information available to market participants in the European and UK loan markets than ever before.

Credit-granting

The credit-granting requirements of the Securitisation Regulations were introduced in the context of the Financial Crisis. The criteria apply to sponsors, originators and original lenders of securitisations when granting credits and therefore apply to the diligence and verification of the underlying loans in CLOs.

Article 9(1) of the Securitisation Regulations includes criteria that sponsors, originators and original lenders are required to apply when granting credits in respect of the underlying assets which are intended to be securitised. Such parties are required to apply the same 'sound and well-defined criteria for credit-granting' that are applied to assets not to be included in securitisations. The intention is to ensure originators of assets are securitising assets that receive the same level of diligence as if the originator were to retain the asset, without transferring away to a securitisation and otherwise avoiding securitising lesser quality assets than an originator holds on its balance sheet – commonly referred to as 'cherry pickers'. The requirements also extend to such parties having effective systems in place to ensure that credit-granting is based on a thorough assessment of the underlying obligor's creditworthiness.

The collateral manager or a third party originator under CLOs will most commonly qualify as an originator under the Securitisation Regulations by purchasing loans on its own account prior to securitising such loans under the CLO (a 'limb (b) originator') and instead of Article 9(1) applying as above, under Article 9(3) of the Securitisation Regulations, sponsors, originators and original lenders undertaking such origination activity in respect of a securitisation must instead verify that the entity involved in the original agreement creating the loan to be purchased and securitised fulfilled the requirements under Article 9(1) of the Securitisation Regulations.

This raises issues around verification of the activities of an unrelated third party, which can be difficult to establish in practice, given the trading of loans and potential unavailability (or unwillingness to assist) of original lenders, when the collateral manager is purchasing a loan some time after its original syndication.

Where the asset creator of a loan is an EU credit institution authorised under the CRR however, a limb (b) originator should be able to take comfort that the loan was originated in line with Article 9(1), as Article 408 of the CRR sets out identical requirements in respect of EU credit institutions to that in Article 9(1) of the Securitisation Regulations as well as certain additional guidelines on loan origination and monitoring.

A limb (b) originator determining that the asset creator is an EU credit institution could therefore be regarded as the verification that the asset creator complied with Article 9(1), at least where such limb (b) originator is not aware of any breach by the asset creator of its regulatory obligations under the CRR.

As regards any minimum standard of origination required by Article 9(1) and to be verified by a limb (b) originator under Article 9(3), a collateral manager on a CLO transaction that is a limb (b) originator, which receives full information in relation to the borrower under a syndicated leveraged loan, whether because the borrower is a listed corporate or because such information is made available to it under the terms of the loan agreement, may take the view that it is in a position to assess whether the asset creator carried out a thorough assessment of the obligors' creditworthiness.

Future of the Securitisation Regulations

As required under Article 44 of the EU Securitisation Regulation, the Joint Committee of the European Supervisory Authorities (ESAs) published a report (the 'JC Report') on 17 May 2021 on the implementation and functioning of the EU Securitisation Regulation, addressing a number of features of the Securitisation Regulations, including those discussed in this chapter. The report also references an opinion given by the ESAs to the European Commission on 26 March 2021 relating to the jurisdictional scope of the application of the EU Securitisation Regulation (the 'Opinion').

The aim of the JC Report is to provide a summary of the status of the EU Securitisation Regulation and to identify existing issues, in some cases recommending improvements or solutions to those issues. The ESAs are not directly empowered to change EU legislation or offer interpretative guidance on the meaning of the framework text in the EU Securitisation Regulation. The Opinion consists of recommendations to the Commission but is not binding on market participants. The views expressed may, however, be a very good indication of the direction of travel at the EU level.

One of the key aspects to arise from the JC Report and the Opinion relates to the lack of clarity around the jurisdictional scope of the obligations under the EU Securitisation Regulation, some of which has been discussed in this chapter. The ESAs recommend that the European Commission should issue interpretative guidance in the areas where legislative change is not required, or otherwise proposals to amend the EU Securitisation Regulation as part of its scheduled review process.

The Opinion sets out the ESA's views on the practical difficulties faced by market participants in connection with the jurisdictional scope of application of various EU Securitisation Regulation provisions in transactions where there is an element of EU involvement and an element of third country (i.e., non-EU) involvement, including securitisations where some, but not all, of their 'sell-side' (i.e., sponsor, originator, original lender or SPV) are located in a third country, and securitisations where all sell-side parties are located in a third country and EU investors invest in them.

The Opinion confirms that in respect of securitisations with no sell-side party located in the EU, the EU Securitisation Regulation does not directly apply to those parties. However, where either there is at least one EU sell-side party (other than the SPV except in the case of Article 7 of the EU Securitisation Regulation) the JC Report and Opinion suggest that the party located in the EU will: (1) have sole responsibility for retention under Article 6 of the EU Securitisation; and (2) be designated as the responsible party for the transparency obligations under Article 7 of the EU Securitisation Regulation; and (3) have responsibility for ensuring credit-granting on the underlying assets. This creates potential issues for EU sell-side parties collaborating with non-EU sell-side parties on securitisations.

The Opinion also considered the lack of clarity around the application of Article 5 of the EU Securitisation Regulation to investors investing in securitisations where there is a third country (i.e., non-EU) nexus. While it is clear that EU institutional investors are under an obligation to verify that a securitisation based in a third country has complied with the risk retention and credit-granting requirements, as discussed above, it is less clear whether the investor due diligence requirements can be satisfied in relation to transparency requirements where the templates set out in the Reporting Templates RTS have not been used. The ESAs expressed the view that this means that it is 'very unlikely, or at least very challenging', for EU institutional investors to be able to comply with the EU Securitisation Regulation when investing in a third country securitisation in that scenario.

The proposed solution to this lack of flexibility inherent in Article 5 is the ESAs' request that the Commission consider whether an 'equivalence regime' for third country securitisations should be put in place. In order for the third country's laws relating to securitisation disclosures to be deemed 'equivalent', the ESAs suggest that those laws should impose on the securitisation's sell-side parties an obligation to disclose to institutional investors:

- 'the same or substantially similar information' as Article 7 of the EU Securitisation Regulation;
- with 'sufficient' frequency even if frequency is not identical to Article 7 of the EU Securitisation Regulation; and
- information that should be provided in the form of templates of similar quality and granularity to that prescribed by the Reporting Templates RTS.

Following an assessment of a third country's securitisation regime for these purposes by ESMA, the Commission would then declare such a regime to be equivalent, meaning that the due diligence obligations in Article 5 relating to transparency would be met where the investor could verify the information described above had been provided.

Notably, the first two of the equivalency requirements above are similar to the position taken under the UK Securitisation Regulation as discussed above. However, the requirement for this to be prescribed by law and then declared as an equivalent regime rather than simply being a requirement to obtain such similar information, as well as the third requirement for such law to be equivalent specifying reporting templates, means that from a practical perspective, any equivalence will be very challenging, as many jurisdictions including, for example, the US, do not have a regulatory regime similar to Article 7 of the EU Securitisation Regulation.

As regards the existence of two Securitisation Regulation regimes, following the departure of the UK from the EU, the implementation of the UK Securitisation Regulation and the separate UK regulatory regime, while there is some divergence (for example, on the clarifications around jurisdictional scope discussed above), this has not, at the time of writing, resulted in significantly differing regulatory frameworks in the UK and the EU.

Over time, however, divergence between the two Securitisation Regulations is unfortunately inevitable. Amendments made, for example, pursuant to the Joint Report or as recommended by the Opinion mentioned above to the EU Securitisation Regulation may never find their way into the UK Securitisation Regulation (and, of course, vice-versa for amendments to the UK Securitisation

Regulation made over time). Furthermore, if requirements such as the equivalency regime in respect of Article 7 of the EU Securitisation Regulation discussed above are implemented, despite the similarity of the UK and EU regimes, it is possible that an equivalence assessment (or similar for other requirements in future) for the UK transparency regime could be subject to delays, or even a refusal by the Commission to grant equivalence and, as a result, the regimes will move further apart.

Similarly, as the UK seeks to operate more independently of its EU neighbours, practices on enforcement (which are prescribed under the EU Securitisation Regulation, but not the UK Securitisation Regulation) and amendments to the UK Securitisation Regulation may not be replicated in the EU.

The potential divergence of regimes presents challenges to CLO managers seeking to comply with both Securitisation Regulations to continue to attract investors from the UK and the EU. Regulatory divergence will only complicate a CLO market that is vital to the optimal functioning of the UK and European loan market, potentially resulting in a fracture thereof, with investors being limited in their investments as a result of non-compliance with a particular regulation and potentially slowing or limiting critical funding to the leveraged and mid-cap loan markets. The LMA will, of course, be taking an active role in responding to consultations and meeting with relevant parties, to ensure CLOs can remain a valued tool in European corporate finance.