Client Alert

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Structured Finance

Capital Retention Requirements for Managed CLO Transactions

The difficulties experienced by the financial sector in Europe over the past few years have resulted in a strengthening of the European regulation of securitisation transactions. Article 122a of Directive 2006/48/CE[1] as modified by Directive 2009/11/CE[2] (the "**CRD**") has regulated the capital retention requirements associated with securitisation transactions in Europe since 1 January 2011. These regulations are currently undergoing modification with a view to rendering them more appropriate for application to different types of securitisation transactions, including managed collateralised loan obligation securitisations ("**CLO**"). This Client Alert first summarises the existing regulatory texts, before examining the new provisions that are currently in the process of implementation.

Article 122a

Pursuant to Article 122a(1) of the CRD:

"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 %" (the "**retention requirement**").

This Article came into effect across the European Union on 1 January 2011. It applies to credit institutions regulated in the EEA when they invest in securitisation transactions.

The retention requirement arose as a consequence of the financial crisis and has two primary aims. The first aim is to avoid the securitisation of assets that bear too great a risk, and a risk that originators would not otherwise be willing to take on themselves. It is assumed that less risk will attach to securitised assets where the interests of the entities originating the assets are aligned with the interests of those investing in the assets on the basis that transaction decisions are more likely to be made in accordance with investor interests. The second aim is to encourage investors to be more cautious when they invest in a securitisation. Investors must ensure that the retention requirements are met. Failing to do so, whether by negligence or by omission, can result in the imposition of a proportionate additional risk weight of at least 250 %, and up to a maximum of 1250 % of the risk weight which will otherwise apply to the relevant securitisation positions imposed by the CRD.

[1] Directive of the European Parliament and European Council dated 14 June 2006 relating to the taking up and pursuit of the business of credit institutions.
[2] Directive of the European Parliament and European Council dated 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management.

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Article 122a provides various options whereby the retaining entity can fulfil the retention requirement. According to the terms of the CRD, a "retention of the net economic interest" can be met by any of the following:

- *"retention of no less than 5 % of the nominal value of each of the tranches sold or transferred to the investors";*
- *"in the case of securitisations of revolving exposures, retention of the originator's interest of no less than 5 % of the nominal value of the securitised exposures";*
- *"retention of randomly selected exposures, equivalent to no less than 5 % of the nominal amount of the securitised exposures, where such exposures would otherwise have been securitised in the securitisation, provided that the number of potentially securitised exposures is no less than 100 at origination";* or
- *"retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total no less than 5 % of the nominal value of the securitised exposures".*

In a further effort to ensure the creditworthiness of securitised assets, Article 122a also requires that EU credit institutions investing in securitisation positions comply with specific due diligence requirements both prior to investing, and for the duration of a transaction. These include, amongst other things, a requirement that investors be able to demonstrate to competent authorities their understanding of the information disclosed by retention holders under Article 122a(1), as well as of the underlying risk characteristics of pooled assets and the *"statements and disclosures made by the originators or sponsors, or their agents or advisors, about their due diligence on the securitised exposures and, where applicable, on the quality of the collateral supporting the securitised exposures"*.

Article 122a further requires that sponsors and originators be EU credit institutions and that such institutions use prudent and well-defined underwriting criteria when originating those assets to be securitised. In addition, such institutions must apply the same underwriting standards to those assets as they would apply to assets held on their own books and to ensure that sufficient information is provided to investors so as to enable compliance with due diligence requirements. Such information must include all material data as to the quality of the credit and performance of the individual underlying exposures, cash flows and collateral supporting the underlying exposures.

The implementation of Article 122a has been met with considerable concern from market participants. Much of this concern arises from the apparently broad application of Article 122a and the extensive scope of its definitions.

The retention requirement presents a particular challenge in the context of CLO transactions. By their very nature, such transactions involve neither an originator nor the original lender, and often it is only the sponsor that is available to act as retention holder for the purposes of Article 122a. Following the definitions contained in the CRD, a "sponsor" must be a credit institution. However, where this is not the case, the question arises as to how a CLO structure can comply with the retention requirement. This matter was addressed in the CEBS Guidelines (as defined below).

CEBS Guidelines

The Guidelines to Article 122a of the CRD published by the Committee of European Banking Supervisors (the "**CEBS**") on 31 December 2010 (the "**Guidelines**") addressed a number of concerns raised in relation to the application of Article 122a. Concerning the retention requirement in the context of CLO transactions, the Guidelines acknowledge that there may be circumstances where the sponsor is not a credit institution, and as it is not always possible to identify a "classic" originator in the context of a CLO transaction, no party would strictly be eligible to hold the required retention.

Paragraph 25 of the Guidelines provides that in such cases, on the condition that the transaction still constitutes a securitisation for the purposes of the CRD, the retention requirement may be fulfilled by whichever party would most appropriately fulfil the role of retention holder (notwithstanding the specific constraints of the definitions contained within the CRD). This analysis takes a purposive approach, taking into account the overall intention of the Article 122a provisions, namely to align the interests of investors with the party to the transaction that is actively transferring a proportion of the risks and rewards of the underlying exposures or positions to those investors.

Paragraph 26 of the Guidelines further acknowledges that there are transactions in which there may be a party that does indeed meet the definition of originator or sponsor, or fulfil the role of original lender, but where the interests of a party that does not fulfil any of these definitions are more strongly aligned with those of the investors. The Guidelines cite: *"[Asset managers] of a securitisation where there is on-going management and substitution of exposures (where such asset manager is not a credit institution)"* as an example. In such cases, the Guidelines provide that *"it is possible that such an entity could fulfil the retention requirement by means of an SPV that is established to act as "originator" (for instance by purchasing the exposures to be securitised), with such an SPV consequently meeting the definition of the term "originator" under the [CRD], but which then, in turn, has its retained credit risk assumed by (and potentially also its funding provided by) that entity that neither meets the definition of originator or sponsor nor fulfils the role of original lender".*

The Guidelines make it clear that the entity fulfilling the retention requirement should be the entity whose interests best align with those of investors[3].

Following the Guidelines therefore, and subject to certain conditions, the asset manager or the most subordinated investor in a CLO may act as retention holder despite not meeting the precise definition of original lender, originator or sponsor under Article 122a.

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[3] Paragraph 26 further provides that such arrangements must not be relied upon as a mechanism for redistributing the retained exposure to other investors.

EBA Q&A on Guidelines

The Q&A on Guidelines to Article 122a of the CRD (the "**Q&A**") published by the European Banking Authority (the "**EBA**", formerly the CEBS) on 29 September 2011 in response to numerous questions received by the EBA from competent authorities and market participants, consider specifically how Article 122a is to apply in the context of CLO transactions. Amongst other things, the Q&A clarify that an equity investor retention holder may satisfy the requirements of Article 122a if it is involved in the structuring of the transaction and the selection of the initial portfolio, including the negotiation of eligibility criteria and reinvestment restrictions. Such an equity investor would also need to be "involved" in any material amendments and/or adaptations to the existing transaction. The equity investor retention holder would not however need to be involved in the approval of investment decisions during the ramp-up and reinvestment periods of the CLO. The Q&A further specify that the Article 122a retention requirements may also be fulfilled by group affiliates of the manager of a CLO transaction, provided that any such affiliate is consolidated at the group level.

Capital Requirements Regulation

The Capital Requirements Regulation adopted by the Council of the European Union on 20 June 2013 (the "**CRR**") will replace Article 122a in its entirety from 1 January 2014. Articles 405 to 409 of the CRR, as published in the EU Official Journal on 27 June 2013, relate specifically to capital retention requirements. They alter the former requirements under Article 122a in a number of ways.

Firstly, the definition of sponsor is widened to include investment firms in addition to credit institutions. Investment firms are defined as MiFID-regulated portfolio managers, but excluding those that are not authorised to:

- provide safekeeping and administration services in relation to financial instruments for the account of clients;
- receive and transmit orders in relation to one or more financial instruments;
- execute orders on behalf of clients;
- manager portfolios;
- provide investment advice; or
- hold client money or securities.

The definition therefore excludes alternative investment fund managers and non-EU investment advisers, restricting the nature of the entities that can act as retention holder.

Secondly, the CRR provides an additional option for the retention holder to satisfy retention requirements through the retention of a first loss exposure of no less than 5 % for every securitised exposure.

It is important to note that the CRR does not contain any grandfathering provisions for transactions that close before it comes into force. Since the publication of the Technical Standards (as defined below), market participants have effectively been put on notice of the forthcoming legislation, and investors run the risk of being required to comply with additional risk weights in the event of material non-compliance with the retention requirements.

Draft EBA Regulatory Standards

Through Article 410 of the CRR, the EBA was granted a mandate to develop draft regulatory technical standards to specify in greater detail those requirements in Articles 405 and 406 that apply in the context of institutions which are exposed to securitisation risk, including the qualifying criteria in respect of a material net economic interest referred to in Article 405, together with the level of retention.

Draft regulatory technical standards and draft implementing technical standards were put forward by the EBA in a consultation paper on 22 May 2013 (the "**Technical Standards**"). These Technical Standards are currently open to comment from market participants until 22 August 2013, prior to the EBA submitting the Technical Standards to the Council of the European Union on 1 January 2014. Currently, it is difficult to ascertain the extent to which the wording of the drafting of the Technical Standards may change, but the EBA will not in any event depart from the provisions of the CRR. Following submission on 1 January 2014, the Council will have three months in which to decide whether or not to endorse the Technical Standards as drafted[4].

In a significant departure from the Q&A, the Technical Standards do not allow for a third party equity investor to act as the retention holding entity. This is because the EBA considers that, in the case of CLO transactions, a broadening of the definition of sponsor for the purposes of the CRR will be sufficient to allow the retention requirement to be met by the investment firm who manages that CLO.

Effects on Managed CLO Transactions and Co-management Structures

The reduced flexibility resulting from the exclusion of third party investors from the list of potential retention holders as provided by the Technical Standards is an issue for CLO transactions, notably because (i) the definition of investment firm for the purposes of the CRR will not be wide enough to ensure that all types of collateral manager fall within the definition of sponsor, and (ii) even where collateral managers do fit the definition of sponsor, not all collateral managers will have the requisite capital resources to act as retention holders, especially given that the retained capital must remain un-hedged for the duration of the CLO. The EBA has acknowledged this effect of the Technical Standards in stating that: *"this [requirement] could potentially translate in the long term to a modification of the currently existing managed CLO model".*

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[4] Article 10, Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 20 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.

It is important to note however, that despite the obligation to maintain the 5 % retention un-hedged, the EBA consultation paper clarifies the fact that it is still possible to retain risk in any of the ways set out in Article 405(1) of the CRR on a synthetic or contingent basis, including through the use of derivatives, provided that certain conditions are met. In addition, nothing appears to prevent the refinancing of a 5 % retention on a collateralised basis, i.e., a financing could be granted to the retention holder by a third party and secured by a pledge over the retained 5 % net economic interest.

Although the new legislation is likely to create challenges in the future for the structuring of CLO transactions, the market has a long history of adapting to changes in regulatory demands, and there is no reason why this should not continue. Indeed, as market participants look for ways to comply with new developments in relation to retention requirements whilst continuing to invest in the CLO model as a commercial opportunity, a number of creative solutions are being envisaged. A sharing of the 5 % retention requirement is increasingly being considered in view of the significant, and in some cases prohibitive, capital reserves necessary to comply with retention requirements. Article 4 of the Technical Standards allows for this in principle such that, although a retained economic interest may not be split between different types of retainer (i.e., between originator, sponsor or original lender), it may be split between more than one originator, sponsor or original lender where the relevant securitised exposure was created or sponsored by multiple originators, sponsors or original lenders. As such, the Technical Standards contemplate that a retention requirement might be fulfilled by the originator, sponsor or original lender with respect to that proportion of the total securitised exposures for which it is originator, sponsor or original lender.

However, the Technical Standards are not entirely clear as to how the risk exposure of a given entity is to be calculated. It is likely that this calculation will be based on economic rather than legal factors, and more precisely upon the actual economic risk to which the sponsor, originator or original lender will itself be exposed. The calculation mechanism remains a question that will need to be raised during the current consultation phase, and it is hoped that the EBA responses will provide further clarity. A calculation mechanism may involve a simple pro rata calculation or, alternatively, take into account the decision-making mechanisms with respect to the assets within the transaction. It is more likely, however, that the remuneration of the co-managers, in conjunction with the respective risks that each co-manager may take in respect of the performance of the assets (by way of incentive fees, for example) will provide a more certain indicator for the pro rata allocation of the retention percentage.

Although the principles of the new legislation are unlikely to change prior to implementation in the first quarter of 2014, the exact wording of the Technical Standards is likely to undergo further modification. As such, market participants remain reluctant to structure new CLO transactions due to the residual uncertainty as to the final form of the legislation.

The Structured Finance Team at Gide is in close contact with the EBA for the purposes of clarifying the application of the forthcoming legislation, especially in the context of CLO transactions. The Team will continue to work alongside other market participants until a satisfactory resolution of these issues is achieved.

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