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5 October, 2015

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CLO Group Client Alert

CLOs & European Risk Retention: Changes Proposed in the New Securitisation Regulation

On 30 September 2015, following two separate unauthorised "leaks" to the financial press of early drafts, the European Commission published its official draft proposal for the new Securitisation Regulation[1].

Once finalised and in force (see below for further detail), the Securitisation Regulation is intended to replace and consolidate in a single regulation the existing European risk retention regime that is currently scattered across several different pieces of legislation. From a substantive perspective, most aspects of the risk retention regime will remain the same. However, as we highlight below, there are some crucial differences which will impact the European CLO market (and the US CLO market with respect to transactions that aim to be compliant with the Existing Rules and the Securitisation Regulation) if the Securitisation Regulation is implemented in its current draft form.

EXISTING POSITION

Currently the regulatory framework for risk retention in Europe is implemented by four different pieces of primary legislation (together, the "**Existing Rules**")[2] which require that an entity[3], other than when acting as an originator, a sponsor or original lender, shall be exposed to the credit risk of a securitisation position only if the originator, sponsor or original lender has explicitly disclosed that it will retain, on an ongoing basis, a material net economic interest which, in any event, shall not be less than 5% (the "**Retention Requirement**").

The Existing Rules impose what is known as an "indirect" compliance obligation, as it is investors who are required to comply, rather than the entity that actually holds the 5% retention (the "**Retention Holder**"), in contrast to the US risk retention rules which become effective in December 2016. Consequently, most focus under the Existing Rules has been on confirming whether, and exactly how, any particular Retention Holder is eligible to act in such capacity. In addition, the Existing Rules also impose significant diligence obligations on investors[4].

BACKGROUND TO THE CHANGES

The European Commission recognises that securitisation is an important element of well-functioning capital markets, necessary for diversifying funding sources and allocating risk efficiently within the EU financial system[5]. It also observes that post-crisis European securitisation markets have remained subdued when compared to the United States, notwithstanding significantly lower default rates[6]. The Securitisation Regulation is part of the European Commission's attempt to restart the securitisation markets on a sustainable basis[7].

The Securitisation Regulation also introduces certain amendments in light of the recommendations made by the European Banking Authority (the "**EBA**") in its report on risk retention published 22 December, 2014 (the "**2014 Report**")[8]. In the 2014 Report, the EBA in particular recommended that the European Commission revisit the definition of an "originator" in order to reduce a perceived misuse of the rules by virtue of a supposed "legal loophole", as well as revisiting disclosure and due-diligence requirements and, finally, to look at a move to direct application of the Retention Requirement.

DESCRIPTION OF PRINCIPAL CHANGES

(a) The move to direct application

The Securitisation Regulation contemplates a move to "direct" application of the Retention Requirement, in that Article 4(1) requires the originator, sponsor or original lender of a securitisation to retain a 5% interest on an ongoing basis.

As noted above, by contrast the Existing Rules apply "indirectly" by requiring that the *investor* exposed to the credit risk of a securitisation may only hold a securitisation position where the relevant Retention Holder has explicitly disclosed to such investor that it will retain a 5% interest on an ongoing basis. The rationale for the current approach, as explained by the EBA in their 2014 Report, is to encourage investors to only purchase securitisation exposures following proper due diligence and once they fully understand the risk they are taking on. In practice this means that for an investor to discharge this obligation satisfactorily, the investor must establish that the purported Retention Holder does in fact qualify as a sponsor, originator or original lender. In part this is achieved contractually, as it has become market practice to require Retention Holders to enter into a "risk retention letter", containing representations and warranties as to the Retention Holder's status as a qualifying entity under the Existing Rules and covenants regarding factual elements of the Retention Requirement.

Notwithstanding this, in its 2014 Report the EBA expressed the view that placing the obligation to comply with the Retention Requirement directly on the relevant Retention Holder "could, while causing potential additional costs for originators, original lenders and sponsors, reduce compliance costs and improve legal certainty for investors, thereby encouraging new securitisation investors to invest". The EBA further noted, in a nod to the soon to be effective US risk retention rules that will also apply a direct approach, that "a move towards the direct approach could also bring some benefits in terms of cross-border consistency".

Curiously, Article 4(1) is not drafted to apply only to securitisations or Retention Holders established in the European Union, and thus the provision purports to have extra-territorial effect and would apply to, for example, Retention Holders based in the United States even without any other connection to Europe. Given the general reluctance of the European legislative bodies to legislate outside of European borders, in our view this is probably unintentional and should be corrected in the final draft. This view is supported by commentary in the preamble to the Securitisation Regulation, which notes with approval that the indirect approach will continue to apply where the Retention Holder is not established in the European Union (because it applies to European investors), suggesting that the direct approach is *not* intended to apply to foreign Retention Holders.

In our view, whilst representing a significant conceptual shift in approach, the move to "direct" application does not have significant practical consequences for Retention Holders because the resulting regulatory obligations largely mirror what the market already requires on a contractual basis.

(b) Restrictions on "originators"

The Securitisation Regulation contemplates disqualifying from acting as eligible Retention Holders those entities that, whilst otherwise meeting the legal definition of "originator", are nonetheless established or operate for the "sole purpose" of securitising exposures.

Structures utilising Retention Holders purporting to qualify as "originators" have come under particular scrutiny and critique by the EBA and other regulatory and quasi-regulatory bodies. For example, in its 2014 Report the EBA noted that "the wide scope of the definition of 'originator'...[means] it is possible to structure securitisation transactions so as to meet the legal requirements of the regulation without following the 'spirit' of the regulation and which do not...align the interests of the most appropriate party to retain...with the interests of investors".

By introducing the "sole purpose test"[9], the European Commission intends to exclude entities that do not have a sufficient alignment of interest with investors. As a practical matter, Retention Holders that sell assets from their balance sheet to a CLO vehicle or other securitisation (thereby 'securitising' them) hoping to qualify as "originators" will need to demonstrate substantial other business in order to avoid falling afoul of the restriction in Article 4(1).

There are two obvious paths (both with existing established market precedent in Europe) by which an originator can demonstrate such other business. Firstly, an "originator" that also acts as the manager of the relevant CLO will, provided that it has sufficient independent substance, have a clearly identifiable line of other business in the provision of collateral management services in return for remuneration. This is the path already taken by European capitalised manager vehicle (CMV) structures purporting to be compliant with the Existing Rules that we expect to increase in popularity in Europe given the clear route to compliance under the new Securitisation Regulation . Secondly, an "originator" that has a significant business line either (a) trading loans in the secondary market or (b) that engages in direct-lending will also be able to demonstrate that it falls outside of the restriction created by Article 4(1). This is the route already taken by many European business development company (BDC) structures that we expect to remain a popular option.

One problem with the existing draft of Article 4(1) that we hope to see corrected before the legislation is finalised is that relating to the 'innocent originator'. Article 4(1) currently provides that where the originator, sponsor or the original lender have not agreed between them who will retain the material net economic interest, the originator shall retain the material net economic interest. This potentially shackles the loan market as any entity that is the original lender for a loan that is ultimately sold to, and any entity that sells a loan to, a CLO is potentially an originator. This raises the spectre of a non-compliant transaction inadvertently dragging any such 'innocent originator' into a direct compliance obligation, which is surely illogical and most likely an unintended consequence of the drafting of Article 4(1).

(c) STS and non-application to CLOs

The Securitisation Regulation establishes a new sub-category of securitisation transaction – **S**imple, **T**ransparent, **S**tandardised (**STS**) – which will be eligible for a marginally lower regulatory capital charge.

Though not unexpected, the Securitisation Regulation makes it clear that CLOs will not be able to benefit from STS status because they will not meet certain of the criteria set down by Chapter 3. In particular, in order to qualify as STS, securitisations should not be actively managed (as are the vast majority of CLOs).

Given that active management was a hallmark of the exceptional performance of the CLO sector throughout the financial crisis, that this approach seems illogical is axiomatic. Nonetheless, as previous lobbying efforts have not come to fruition at this stage in the legislative process we are not hopeful that CLOs will become eligible to qualify as STS in the final draft of the Securitisation Regulation. That said, given the limited benefits accruing to STS status we do not view this as a particular downside for the industry and it may even be positive for the CLO investor base given the possibility of a divided market justifying or requiring slightly increased yields.

LEGISLATIVE PROCESS & TIMING

Unlike previous iterations of the Securitisation Regulation, this latest draft does not purport to have retrospective effect (other than, to a limited and largely non-controversial extent, in respect of the due diligence obligations contained in Article 3). The transitional provisions contained in Article 28 provide that the new requirements outlined above will only apply to securitisations with an issue date on or after the date of entry into force of the Securitisation Regulation. Existing deals are therefore 'grandfathered'.

Article 31 provides that the Securitisation Regulation shall enter into force on the twentieth day following its publication in the Official Journal of the European Union. However, this draft is subject to review and comment by both the European Parliament and Council and, at the outside, could be up to six months away from finalisation. Our expectation is that the final Securitisation Regulation will come into force during the summer of 2016. In light of the extensive lobbying efforts already undertaken by market participants we do not expect further significant changes to be made. We will, however, be submitting suggestions for a number of improvements and clarifications, not least in respect of the curious omission of the carve-out previously afforded to sponsors, originators and original lenders that were acting in such capacity which previously meant that CLO warehouses in most cases did not need to be retention compliant from the perspective of the arranging bank.

Finally, whilst Article 28(5) of the Securitisation Regulation provides that the CRR RTS shall apply in the interim (thus providing useful short-term guidance and certainty on points of interpretation covered thereby, such as the threshold origination percentage for non-manager originators and the ability for the Retention Requirement to be fulfilled by multiple originators), Article 4(6) mandates the EBA to produce a draft of the replacement for the CRR RTS within six months of the entry into force of the Securitisation Regulation. However, until a draft of the new RTS appears, the industry will be hindered by the prospect of further significant changes.

Finally, looking forward, Article 30 mandates the European Commission to produce a report four years after entry into date of the of the Securitisation Regulation on the

functioning thereof including, "where appropriate" a legislative proposal for required changes. It seems, therefore, that the "new normal" for the securitisation industry in general and the CLO industry in particular is one of perpetual regulatory evolution.

NOTES:

[1] Regulation laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation and amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012 (the "**Securitisation Regulation**").

[2] Being the *Capital Requirements Regulation* (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) for credit institutions (banks), the *Solvency II Directive* (Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)) for insurers, and the *UCITS* (Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)) and *AIFMD Directives* (Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010) for asset managers, as well as certain pieces of secondary legislation including most pertinently the *CRR RTS* (Commission Delegated Regulation (EU) No 625/2014 of 13 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council by way of regulatory technical standards specifying the requirements for investor, sponsor, original lenders and originator institutions relating to exposures to transferred credit risk).

[3] Note that the Securitisation Regulation will extend the application of the due-diligence obligations contemplated by the new Article 3 to Undertakings for Collective Investments in Transferable Securities (UCITs) and Institutions for Occupational Retirement Provision (IORPs) in addition to banks, insurers and other asset managers. In addition to establishing that an appropriate entity fulfils the Retention Requirement, investors must also diligence compliance with the disclosure and transparency requirements required by Article 5 of the Securitisation Regulation and undertake steps to appraise themselves of the risk characteristics of the underlying assets and the pertinent structural features of the securitisation itself. Our expectation is that compliance with Article 3 will manifest itself as increased focus on the disclosure documentation (offering memorandum or prospectus) and internal checks and procedures at investor institutions.

[4] Please refer to our previous briefing entitled "*Risk Retention Reinvention: Some questions answered*" for full details of the Existing Rules and for commentary on challenges of interpretation thereunder. A copy may be found here: http://digital.milbank.com/i/133527-risk-retention-reinvention-some-questions-answered

[5] Preamble to the Securitisation Regulation, beginning page 2, paragraph 4.

[6] *Ibid.*

[7] The preamble to the Securitisation Regulation notes that the European Commission's underlying rationale is to "permit the healthy and competitive functioning of European capital markets, whilst at the same time protecting investors and managing systemic risk by avoiding a recurrence of the flawed "originate to distribute" model" of securitisation.

[8] https://www.eba.europa.eu/documents/10180/534414/Securitisation+Risk+Retention+Report.pdf

[9] Earlier drafts of the Securitisation Regulation contemplated a rather more ambiguous "primary purpose" test. Readers may note that Milbank, in collaboration with a number of other leading law firms active in the CLO-sector, wrote to the European Commission and the EBA following the "leaked" first draft of the Securitisation Regulation to suggest alternative proposals including the "sole purpose" test forming the basis of the current draft.

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