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Insights

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Final Risk Retention RTS Adopted and Published by the European Commission

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On 7 July 2023, the European Commission adopted and published the final text of the Regulatory Technical Standards (the "**RTS**") specifying risk retention requirements for originators, sponsors and original lenders pursuant to Article 6(7) of Regulation (EU) 2017/2402 (the "**EU Securitisation Regulation**")[1]. The Commission-adopted text will now be reviewed by the European Parliament and Council and, if endorsed by both bodies without objection, the RTS in its current form will be published in the Official Journal of the European Union and gain full legal effect, possibly as early as September 2023.

The RTS' entry into force is eagerly anticipated. The European Banking Authority (the "**EBA**") originally proposed the draft RTS in July 2018 (the "**2018 Draft RTS**"), the provisions of which were embraced by market participants at the time in advance of enactment. Nearly three years later, a revised draft of the RTS was published in June 2021 and the EBA launched a public consultation process (the "**Consultation**") in respect of the proposed amendments to the 2018 Draft RTS, the results of which were published in April 2022 along with further revised draft RTS (the "**2022 Draft RTS**").

The majority of the RTS predominantly reiterate many requirements of the prior Regulatory Technical Standards of 2014[2] (the "**2014 RTS**"), which applies under the EU Securitisation Regulation pending application of the RTS[3] and were originally being promulgated with respect to the risk retention regime under the Capital Requirements Regulation[4]. In particular, the derogations found in the 2014 RTS enabling a single originator to satisfy the 5% risk retention requirement if it has either (a) established and is managing the securitisation or (b) established the securitisation and originated over 50% of the total securitised exposures, remain substantively unchanged[5]. Retention financing also continues to be permitted provided it does not hedge the credit risk of the retention [6].

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1 Note that, following the withdrawal of the United Kingdom (the "**UK**") from the European Union ("**EU**"), the RTS will not be effective with respect of the UK Securitisation Regulation. See Section 5 – UK Securitisation Regulation

2 Commission Delegated Regulation (EU) 625/2014

3 Article 43(7), *EU Securitisation Regulation*

4 Regulation (EU) No. 575/2014

5 Article 3(4), *2014 RTS*; Article 2(4), *RTS*

6 Article 12(2), *2014 RTS*; Article 12(2), *RTS*. Note that Article 12(2) of the RTS is more definitive than the legacy position under the 2014 RTS and specifically permits "*funding arrangements that involve a sale, transfer or other surrender… of the retained economic interest*" (i.e. a title transfer repo).

The RTS do seek to amend and clarify certain other requirements of both the 2014 RTS and the EU Securitisation Regulation and this Client Alert summarises those provisions of particular relevance to the CLO market.

1. Sole Purpose Test

The EU Securitisation Regulation prohibits an entity that has been established or operates for the sole purpose of securitising exposures from acting as an originator-retention holder in a securitisation (the "**sole purpose test**")[7].

The RTS now includes a safe harbour (the "**Safe Harbour**") providing that an entity shall not fail the sole purpose test if it meets the criteria set out in Articles 2(7)(a)[8] and 2(7)(b)[9] of the RTS. Previously these same criteria were instead designated as the factors that were to be taken into account in assessing the sole purpose test.

Industry participants had raised concerns in 2021 that assessing the sole purpose test in this way, with the inclusion of reference to the retainer's "sole or predominant" source of revenue, deviated from existing market practice and might be construed as prohibiting third-party originators from acting as originator-retention holders. The level 1 text of the EU Securitisation Regulation refers only to "the sole purpose of securitisation exposures", and omits any reference to "predominant" and, with the new formulation of the RTS, any doubts as to the intended pre-eminence of the level 1 text have now been removed.

The EBA has also clarified in its analysis of responses received in respect of the Consultation, that the effect of the RTS is not intended to exclude retainers which do not own significant assets other than the exposures to be securitised[10]. The proposed new formulation in Article 2(7) accordingly strengthens our view that the RTS in their present form will not materially impact market practice in regard to satisfying the sole purpose test and compliance with substance requirements.

Separately, the new Safe Harbour refined the language in the 2022 Draft RTS and now refers to the members of an originator's "management body" having sufficient experience to enable the originator to pursue its business strategy (whereas the 2022 Draft RTS placed this responsibility on the originator's "responsible decision makers"). This shift potentially broadens the scope of permitted management structures.

2. Changing Retainer

Whilst a change in retainer is generally prohibited,[11] the RTS list[12] the following exceptional circumstances in which a change of retainer entity is permissible: (a) in the event of the insolvency of the retainer; (b) when, for legal reasons beyond the retainer or its shareholders' control, the retainer is unable to continue acting in that capacity; and (c) in the case of retention on a consolidated basis in accordance with Article 14 of the RTS[13]. In its analysis of responses received in respect of the Consultation, the EBA further emphasised that any such change of retainer entity must be a "*necessary and unavoidable consequence due to reasons beyond the control of the retainer itself and any of its shareholders"* and could not be *"based*

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7 Article 6(1), *EU Securitisation Regulation*

8 Article 2(7)(a) requires that "*the entity has a strategy and the capacity to meet payment obligations consistent with a broader business model that involves material support from capital, assets, fees or other sources of income, by virtue of which the entity does not rely on the exposures to be securitised, on any interests retained or proposed to be retained in accordance with Article 6 of Regulation (EU) 2017/2402, or on any corresponding income from such exposures and interests as its sole or predominant source of revenue*".

9 Article 2(7)(b) requires that "*the members of the management body have the necessary experience to enable the entity to pursue the established business strategy, as well as adequate corporate governance arrangements*".

10 Question 8, *Summary of responses to the consultation and the EBA's analysis*

11 Article 12(1)(b), *RTS*.

12 Article 12(3), *RTS*.

13 Where retention is held on a consolidated basis, transfer of the retention to an affiliate is permitted to ensure that it remains held within the consolidated group. See Article 12(3)(c) and Article 14, *RTS*

on a voluntary decision"[14]. As such, absent the occurrence of any of these exceptional circumstances, retainers may need to consider alternative routes to transfer the retention to another entity, such as a short non-call period or structuring to allow a share sale to divest the business.

3. Measurement of Retention, Fees and Anti-Avoidance

The RTS expressly distinguish between non-performing securitisations ("**NPEs**") and other securitisations when calculating the required 5% retention holding[15]. For NPEs, such holding should be based on the transaction price (i.e. as opposed to the nominal price) by determining the nominal value of the securitised exposures or the issued tranches (where applicable) with reference to the "net value" of the underlying non-performing exposures. By contrast, the RTS are clear that there is no change to the basis of calculation of the 5% retention holding for CLOs and other performing securitisations, which should remain "*based on nominal values*" and "*the acquisition price of assets shall not be taken into account*"[16].

The RTS also include a general "anti-avoidance" provision, requiring that there are "*no arrangements or embedded mechanisms in the securitisation by virtue of which the retained interest at origination would decline faster than the interest transferred*"[17] [18]. This extends to any fees payable to the retainer for additional services[19], for both NPEs and performing securitisations, including CLOs. The RTS clarify that fees must not create a preferential claim in the securitisation cash flows that would effectively result in the retained interest declining faster than the interests transferred to investors. Accordingly, where fees are payable to the retainer on a priority basis (for example, in the context of a CLO where the collateral manager is also the retainer and receives senior and subordinated management fees ahead of payments on the CLO notes) such fees must be "*on an arms' length basis having regard to comparable transactions in the market*" and represent "*consideration for the provision of the relevant service*". Although typical CLO management fees would clearly meet these requirements, more detailed consideration and analysis would be required for other arrangements that could undermine the retained material net economic interest and so fall afoul of the anti-avoidance provision.

4. Origination by way of Conditional Sale Agreements

In its responses to the Consultation, the EBA noted that it had received queries on whether conditional sale agreements[20] commonly used in CLO "originator manager" structures are permissible for the purposes of qualifying an entity as an "originator" and therefore an eligible retainer[21]. The EBA declined to answer this query on the basis that "*the question of whether the "originator" meets the definition of "originator"… and whether the guarantee, put option or contingent repurchase option can be interpreted as equivalent to an actual purchase… [is] outside the scope of [its] mandate for these RTS*". Whilst this question was also raised via the EBA's "single rulebook" Q&A mechanism over a year ago, a response has not been received at the time of writing[22].

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14 Question 1, *Summary of responses to the consultation and the EBA's analysis*
15 Article 9(1), *RTS*.
16 Article 10(1), *RTS*.
17 Article 15(1), *RTS*.
18 Readers may recall that, when amendments to the EU Securitisation Regulation were initially proposed as part of the EU's Capital Markets Recovery Package, it was originally proposed that "*in calculating the 5% retention rate, fees or other structural elements that might in practice be used to reduce the effective net economic interest shall be duly taken into account*" *see* Proposed Amendments to the EU Securitisation Regulation. This language was ultimately constrained to only take into account fees in the final published version of Regulation (EU) 2021/557 (see Article 1(4)(a) thereof), so the "anti-avoidance" provision in Article 15(1) of the RTS reverts to a wider prohibition in line with that prior initial amendment proposal.
19 Article 15(2), *RTS*.
20 Where the CLO manager takes default risk on certain of the assets forming the CLO's collateral via a contingent purchase from the CLO issuer, such that if an asset does default within a specified "seasoning period" (most usually 15 Business Days), the CLO manager is obliged to purchase the defaulted asset onto its own balance sheet.
21 EBA single rulebook question (ID 2021_5851), posted on 14 May 2021.
22 Question 8, Summary of responses to the consultation and the EBA's analysis

It is unclear whether the EBA will consider the query in the context of its "single rulebook" responses and, if so, when any guidance will be forthcoming. However, noting the overall "spirit" of the risk retention rules and the EU Securitisation Regulation, we remain of the view that the CLO manager already has a strong alignment of interest with investors and is therefore an appropriate entity to hold the risk retention interest. As the "sponsor" route to qualification as an eligible retainer is only available to CLO managers with specific European regulatory permissions, the qualification of CLO managers as "originator manager" retainers through origination via conditional sale agreements is an important route to ensuring a robust approach to risk retention compliance in the global CLO market.

5. Cash-collateralisation of Synthetic and Contingent Risk Retention

Consistent with the 2014 RTS, Article 3(2) of the RTS imposes an obligation on a retainer which holds economic exposure via synthetic or contingent means, to fully cash-collateralise its position. The RTS extend the carve-out from this cash-collateralisation requirement (which was previously available to credit institutions only) to investment firms as well as insurance or reinsurance undertakings[23].

6. UK Securitisation Regulation

Following the end of the Brexit transition period and the UK's withdrawal from the European Union at the end of 2020, the UK has applied the "onshored" version of the EU Securitisation Regulation by virtue of the European Union (Withdrawal) Act 2018 (the "**UK Securitisation Regulation**"). The UK Securitisation Regulation mirrors Article 6 of the EU Securitisation Regulation in its requirement for technical standards to be developed in respect of the risk retention requirement, however, the UK Securitisation Regulation requires that these are developed by the FCA and PRA acting jointly. Separately, HM Treasury published on 11 July 2023, a "near-final" version of the Securitisation Regulations 2023, the statutory instrument ("**Draft S.I.**"). Developed by HM Treasury pursuant to the Financial Services and Markets Act 2023, the Draft S.I. will replace the UK Securitisation Regulation and related legislation. The UK government has requested any technical comments on the Draft S.I. by 21 August 2023.

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Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any member of our London Structured Credit Group.

[23] Article 3(2), *RTS*.