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CLO Group Client Alert: CLOs & European Risk Retention: New Securitisation Regulation

More work required – examining new Article 5a imposing originator diligence obligations

Following publication on 30 September 2015 of the European Commission's official draft proposal for the new Securitisation Regulation[1], the text of the first Presidency compromise concerning the Securitisation Regulation (the "**Presidency Compromise**") was released on 9 November 2015[2].

As noted in our previous client alert on the topic of the Securitisation Regulation[3], the new draft regulation features some crucial differences from the existing regulatory framework for risk retention in Europe (the "**Existing Rules**")[4]; most notably the move from indirect to direct compliance with the Retention Requirement[5], which will apply to the European CLO market (and the US CLO market with respect to transactions that aim to be compliant with the Securitisation Regulation), if the Securitisation Regulation is implemented in its current draft form.

The Presidency Compromise proposes a number of predominantly clarificatory amendments to the Securitisation Regulation. However, it also includes a potentially more significant change to the requirements for due diligence to be carried out by originators, sponsors and original lenders.

DESCRIPTION OF PRINCIPAL CHANGES

The Presidency Compromise introduces a new Article 5a (*Criteria for credit granting*) into the Securitisation Regulation. The main obligation is set out in the first paragraph thereof, requiring originators, sponsors and original lenders to "apply the same sound and well-defined criteria for credit granting to exposures to be securitised as they apply to exposures not securitised" (the "**Criteria**").

The Criteria of the first paragraph of Article 5a effectively replicates the corresponding text in Article 408 of the existing Capital Requirements Regulation, with the difference

that Article 5a extends application of the Criteria beyond sponsor/originator institutions[6] to any entity purporting to act as originator, sponsor or original lender in relation to a securitisation. In practice this means applying a common standard to all originators and sponsors in relation to a securitisation, which is understandable and has the benefit of providing a "level playing field".

Of greater interest (and concern) is the second paragraph of Article 5a, which applies solely to originators engaged in secondary market origination, i.e. originators that purchase exposures for their own account, and securitise those exposures by onward sale or assignment to an issuer (known colloquially as "limb (b) origination"). The second paragraph of Article 5a requires such originators to ensure that the entity which was, directly or indirectly, involved in the original agreement creating the underlying obligations (i.e. the primary market originator) *itself* complies with the first paragraph of Article 5a, i.e. that the relevant original lender complied with the Criteria.

We see a number of issues with this which we discuss in more detail below.

COMMENT

Firstly, an originator intending to intermediate a loan between the relevant original lender and ultimate CLO issuer will need to diligence the underwriting standards of that original lender. In the absence of any legislative requirement[7] for original lenders to provide the pertinent information on their underwriting standards, originators will be reliant on the goodwill and cooperation of original lenders and so subject to the vagaries of market forces.

Secondly, the proposal becomes still more problematic where there is one or more additional secondary market participants interposed between the originator and the relevant original lender. In such a situation, the second paragraph of Article 5a would require the originator to diligence back up the "chain" to verify the underwriting standards of the original lender – the feasibility of which is highly questionable.

As it stands, compliance with Article 5a of the Presidency Compromise would likely be achieved contractually and involve assurances from the loan seller as to its underwriting processes. However, such a representation would be completely at odds with current market practice. For example, paragraph 7.1 (*Credit appraisal by Buyer*) of the LMA Standard Terms and Conditions for Par and Distressed Trade Transactions (Bank Debt/Claims) (17 February 2015) reads: "The Buyer agrees that it has satisfied itself as to the creditworthiness of each Obligor and the acceptability of the transaction prior to the Trade Date and the transaction shall not be conditional upon this."

CONCLUSION & NEXT STEPS

In light of the favourable statements of the European Commission with respect to the Capital Markets Union and the European securitisation market[8] and the laudable performance of the CLO industry during the recent financial crisis, this latest addition seems counter-intuitive.

Whether intentional or not, the impact of Article 5a and its potential to eliminate or at least obstruct the secondary market originator structure misunderstands the practicalities of the loan and CLO markets, potentially depriving European businesses and banks of a valuable source of long-term capital. Following the entry into force of the new US risk retention rules, and in light of the missed opportunity to expand the "sponsor" definition in the Securitisation Regulation to include regulated US investment advisers, it will also adversely impact non-European collateral managers seeking to be compliant with both the US and European risk retention regimes, as these managers will need to avail themselves of the originator model in the European market.

Milbank along with other leading law firms in the CLO industry will continue to lobby to improve the Securitisation Regulation.

In our view, the addition of the second paragraph of Article 5a of the Presidency Compromise is superfluous. The underlying legislative aim behind Article 5a is to ensure proper diligence of the quality of the exposures and the creditworthiness of the underlying obligors in a transaction – a task which already in fact occurs in practice as the CLO manager, with its expertise in pricing and assessing credit risk (and, importantly, a remuneration structure predicated on the accuracy of that analysis), applies its own criteria and conducts the relevant processes for approving credits in any given transaction. We would suggest that, given the market has already anticipated and addressed these concerns, this correspondingly obviates the need to impose additional, unrealistic, obligations and liabilities on transaction parties.

In the meantime, as noted in our previous client alert, the Securitisation Regulation does not generally purport to have retrospective effect. Our expectation is that the final Securitisation Regulation will come into force during the summer of 2016. However, transactions that are already at the "warehouse" stage could potentially be caught by Article 5a if the Securitisation Regulation comes into force before the resultant CLO closes. Accordingly, managers of such transactions should give thought now as to their best route to compliance should Article 5a be implemented in its current form.

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**"). Once finalised and in force, the Securitisation Regulation is intended to replace and consolidate in a single

regulation the existing European risk retention regime (currently scattered across several different pieces of legislation).

[2] http://data.consilium.europa.eu/doc/document/ST-13834-2015-INIT/en/pdf

[3] http://www.milbank.com/images/content/2/1/21762/10-5-15-CLOs-European-Risk-Retention-Alert.pdf

[4] 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 and investment firms), 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, the *UCITS Directive* (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 Directive* (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).

[5]The requirement that an entity 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 in the transaction 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 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.

[6] A credit institution or an investment firm (as defined in Article 4(1) of Directive 2004/39/EC ("**MiFID**")).

[7] The Presidency Compromise does not impose a disclosure requirement on original lenders. Future versions of the Securitisation Regulation may address this omission.

[8] See, for example the preamble to the Securitisation Regulation, beginning page 2, paragraph 4; the preamble also 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.

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