Milbank

December 23, 2013

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Alternative Invesments Group Client Alert: Risk Retention Redrafted: More Questions Answered

Back in May 2013, the European Banking Authority (the "**EBA**") had opened a public consultation[1] (the "**Consultation Paper**") on the secondary legislation appropriate to support the risk retention requirements set out in Articles 404-410[2] of the EU Capital Requirements Regulation (the "**CRR**")[3]. Following a public meeting at the EBA's offices in July[4], and the closing of its consultation period in August, the EBA published proposals for this legislation (the "**Final Drafts**") on December 17, 2013, comprising (i) final draft Regulatory Technical Standards (the "**Draft RTS**"), and (ii) final draft Implementing Technical Standards (the "**Draft ITS**"). The Final Drafts are intended to replace the existing non-binding guidance (the "**122a Guidance**") consisting of the Guidelines[5] on Article 122a of the CRD2 published by the EBA's predecessor, The Committee of European Banking Supervisors and the EBA's own Q&A[6] on those Guidelines.

As we commented in our previous Client Alert[7], the Draft RTS significantly redesigned the regulatory regime that had been established by the 122a Guidance and, for Europe's CLO industry, not for the better. Although the Final Drafts demonstrate the benefit of additional time and increased scrutiny, the high-level summary is that the consultation and redrafting process has resulted in relatively few substantive changes, either positive or negative.

In the remainder of this Client Alert, we focus on such changes as are included in the Final Drafts and address a number of questions as they affect Managed CLOs.

Q1. WHERE ARE WE IN THE LEGISLATIVE PROCESS?

A. As well as publishing the Final Drafts on its website, the EBA has sent them to the European Commission, with copies to the European Parliament and Council. The Commission now has 3 months to adopt, amend or reject the Final Drafts; the most likely outcome being that it will adopt the Final Drafts in their current form. Assuming the Commission adopts the Draft RTS as is, the Parliament and Council will then have 1 month to object to it. The Final Drafts (in the case of the Draft RTS, assuming no objection) will then be translated into all 24 official European Union languages, be published in the Official Journal, and take effect 20 calendar days after that publication. Further

consultation and amendment provisions with specific timeframes apply in the event that the Commission amends or rejects the Final Drafts and, in the case of the Draft RTS, if the Parliament or Council objects.

In light of this process, we anticipate that the Final Drafts will not take effect before March 2014 at the earliest. Although our expectation is that the Final Drafts will remain in their current form without further amendment by the Commission, Parliament or Council, the timing of the process means that from January 1, 2014, and until such time as the Regulatory Technical Standards take effect, institutions will find themselves in an unwelcome twilight period; subject to the risk retention provisions of the CRR but lacking the secondary legislation intended to facilitate interpretation and compliance with those provisions.

Q2. DOES THE 122A GUIDANCE NOW CEASE TO APPLY?

A. Not entirely. In their preamble to the Final Drafts, the EBA states that, once implemented, the Final Drafts will replace the current 122a Guidance and that the 122a Guidance will remain relevant in only two specific respects (see "Where do we stand on Grandfathering?" below). Delving deeper into the Final Drafts, however, in particular into the EBA's analysis of the responses to Questions 6 and 8 posed by the Consultation Paper, we see that "all examples included in the CEBS Guidelines … remain available". The particular examples referred to are additional variants of retention available to satisfy risk retention option (d) (retention of first loss tranche) and the EBA has made clear that retention alternatives which were enumerated in the 122a Guidance, but do not feature in the (much shorter) Draft RTS, will generally still be available. The logical inference to be drawn is that parts of the discussion and analysis previously provided in the 122a Guidance remain informative, particularly those parts that previously expanded on provisions of the 122a Guidance that have survived in the Final Drafts.

Q3. WHERE DO WE STAND ON GRANDFATHERING?

A. When the Consultation Paper was published, many market participants were disappointed by the disappearance of the provisions of the 122a Guidance which had been introduced to adapt the new CRD2 provisions designed for balance sheet securitisation to the world of arbitrage deals. For example, these allowed an entity that was not a sponsor, originator or original lender, but which was a third party equity investor or a collateral manager (in each case whose interests were most optimally aligned with those of investors) to act as retainer. Various commentators have suggested that, in the interests of natural justice, those transactions executed in good faith on the basis of compliance with risk retention under the 122a Guidance should be grandfathered and deemed compliant with the new CRR regime. However, the EBA has pointed-out that under European law[8] the Draft RTS may only be used to "supplement or to amend non-essential elements" of the CRR. The only comfort[9] granted to investors in those legacy transactions (which applies equally to any pre-2014 transactions that post-date the Consultation Paper) is to make

clear that competent authorities may take into account the 122a Guidance in determining whether an institution's failure to comply with risk retention under the CRR is a result of negligence or omission and, accordingly, whether regulatory capital should be calculated subject to an additional risk weight. This should conclusively protect existing investors from increased regulatory capital cost, but because it does not apply to post-2014 purchasers does not protect existing investors from any liquidity discount they suffer in marking-to-market their holdings in light of CRR non-compliance and the consequent reduction in the pool of prospective buyers of those holdings.

There is better news on grandfathering for securitisations issued before January 1, 2011 and which add or substitute new underlying exposures after December 31, 2014, with the preservation of the reliefs previously granted by paragraphs 134 and Q&A24 of the 122a Guidance. This affects in particular the tiny number of CLO 1.0 transactions still expected to be in their reinvestment period in 2015 and those CLO 1.0 deals post-reinvestment but with the customary (and very limited) post-reinvestment period substitution rights. The EBA has concluded[10] that its 122a Guidance exempting these transactions from risk retention requirements remains applicable as the scope of risk retention is defined by Article 404 of the CRR which "is not part of the RTS mandate"[11].

Q4. AS A COLLATERAL MANAGER, WILL I QUALIFY AS A "SPONSOR" AND BE ELIGIBLE TO ACT AS THE RETAINER FOR A MANAGED CLO?

A. In May 2013, our conclusion was "probably not". This assertion derived from the "sponsor"[12] definition under CRR which requires a collateral manager to be an "institution"[13] and our observations regarding the restricted MiFID permissions of the majority of European collateral managers, the general lightly-capitalised model adopted by collateral managers, the competing requirements of the Alternative Investment Fund Managers Directive and the lack of an equivalence qualification for non-European managers. Although several collateral managers are currently investigating the EBA's suggestion[14] to explore a long-term modification of the Managed CLO model, as we discuss in the next question, other routes to risk retention by collateral managers now beckon.

Q5. CAN THE RETENTION REQUIREMENT BE FULFILLED BY A SINGLE ORIGINATOR?

Yes. One of the few significant changes in the Final Draft RTS is in respect of the provisions relating to originator retention. Article 4(2) of the Draft RTS had previously made clear that when securitised exposures are created by multiple originators, each originator may satisfy the 5% retention requirement in relation to the proportion of the total securitised exposures for which it is the originator. This, whilst perhaps simply intuitive, did provide useful clarification around the provisions of Article 405 of the CRR. Now, in a constructive contribution for the securitisation industry, arguably inspired by the exhortation from the European Parliament to "follow the fee"[15], the EBA has added a new paragraph to Article 4(2) of the Draft RTS, providing two new possibilities for retention by a single originator:

(a) firstly, Article 4(2)(i) makes clear that just one of multiple originators may fulfil the 5% retention requirement provided that originator "has established and is managing" the securitisation. Interestingly, there is no *de minimis* level of origination specified, and it would appear that the EBA have helpfully recognised that any structure whereby the retaining entity is also managing the securitisation is likely to already have a significant alignment of interest, such as through subordinated management fees, and thus it is acceptable to de-emphasise the source of origination; and

(b) secondly, Article 4(2)(ii) allows a single originator to fulfil the 5% retention requirement where it has "established" the securitisation and has contributed over 50% of the underlying exposures. This makes sense as where there is no on-going management role, there is a greater need to focus on the source of origination to ensure an appropriate alignment of interest. This again is a helpful clarification as it avoids the difficult logistical and administrative issues created where the 5% retention needs to be split between multiple originators, which in the case of a securitisation with a large number of originators might be impractical as a result of note minimum denominations.

Q6. CAN THE RETENTION REQUIREMENT BE FULFILLED BY A SINGLE SPONSOR?

A. Yes. The EBA has also added a new Article 4(3) to the Draft RTS providing that where there are multiple sponsors, the retention requirement may be fulfilled either (i) by the sponsor whose economic interest is most appropriately aligned with investors, or (ii) by each sponsor pro rata in relation to the number of sponsors. This seems a sensible interpretative adjunct to the primary legislation, albeit that it effectively rules-out the option of credit institutions taking sub-management roles in a Managed CLO alongside an investment firm for the purpose of acting as a sole retainer.

Perpetuating a phraseology that appeared in the Consultation Paper, the provision commences with the phrase "Where the securitised exposures have been sponsored…". One possible constrution of this formulation (based on the fact that it is securitisations, not securitised exposures that are "sponsored") is that the multiple sponsor flexibility should be limited to a very narrow range of transactions with loans arranged by a specific group of sponsors. However, we think the better view is that the Article should be read more broadly and construed as beginning "Where a securitisation position has been sponsored…".

Q7. CAN THE RETENTION BE SATISFIED ON A SYNTHETIC OR CONTINGENT BASIS?

A. No. Unprompted (at least by a majority of market participants), the EBA has introduced a new Article 5(2) in the Draft RTS requiring any retainer that is not a credit institution to fully cash collateralise any retention interest retained on a synthetic or contingent basis. As synthetic or contingent retention is permitted subject to cash

collateralisation, it appears that the EBA's focus of concern is credit risk, not alignment of interest and, accordingly, financing of a retained interest in various alternative forms should be unproblematic. However, it is not entirely clear how this discrimination between credit institutions and other retainers accords with the EBA's mandate only to supplement or amend non-essential elements of the CRR and the new Article invites speculation as to possible behind-the-scenes discussions that the EBA has had with the Commission and the Parliament. In any event, other structuring, marketing and rating considerations already made it highly unlikely that a Managed CLO would have utilised the option for retention on a synthetic or contingent basis.

Q8. ARE NON-EUROPEANS SUBJECT TO EUROPEAN RISK RETENTION RULES

A. Generally not. Europe's risk retention requirements are principally aimed at regulated European investors (e.g. credit institutions and investments firms) and those that manage their investments (e.g. Alternative Investment Fund Managers). However European institutions are required to take account of their subsidiaries exposures and, under the 122a Guidance, banks had very limited scope to ignore risk retention requirements in the context of their foreign subsidiaries. In a welcome example of a regulator reining-in its extra-territorial ambitions, new Article 3(4) of the Draft RTS now clarifies that the risk retention requirement under Article 405 of the CRR will not apply in relation to an institution's non-European subsidiaries holding trading book positions that are not material in relation to the overall risk of the group's trading book. The introduction of this provision provides a useful relief for those European institutions with subsidiaries acting as arrangers and market-makers in the US CLO market.

Q9. WILL THE EBA PROVIDE FURTHER GUIDANCE ON COMPLIANCE WITH RISK RETENTION RULES?

A. Yes. Once the Regulations proposed in the Final Drafts have been published in the Official Journal, they will become eligible for questions under the EBA's Single Rulebook Q&A tool[16]. This allows regulators and market participants to ask the EBA questions (and requires them to provide suggested answers) on the Capital Requirements Directive, the CRR and associated technical standards and guidelines and is intended to develop a consistent and effective application of the new regulatory framework across Europe.

From various informal discussions, it is envisaged that CLO lawyers and industry associations will co-operate in the identification, development and submission of pertinent questions and logical responses to address those issues that have arisen from analysis of the Final Drafts. Likely issues for consideration in these questions include:

(a) options whereby a securitisation that was complaint with risk retention in accordance with the 122a Guidance can become compliant with risk retention under the CRR;

(b) the measurement (i.e. as to number or nominal amount) and maintenance of the origination required of a single originator retainer that establishes and manages a revolving securitisation like a CLO; and

(c) any methods by which a CLO with a collateral manager sponsor or originator as retainer may remain compliant with risk retention rules on removal and replacement of the collateral manager.

Q10. WHAT NEXT FOR RISK RETENTION?

A. After four eventful years, and assuming no last-minute upsets from the Commission and Parliament, for Europe the pace of regulatory change in the arena of risk retention is finally slowing. In 2014, the securitisation and Managed CLO industries should now be able to develop and refine structural solutions that address the letter, and spirit, of Europe's revised risk retention requirements, free of the legislative uncertainty that throttled-back the growth of the European CLO market in 2013. Much of the international CLO market's regulatory focus will now switch across the Atlantic, where risk retention rules are developing under the auspices of the Dodd-Frank Act[17].

However, Europe's regulators are not altogether done with risk retention. From the Commission, Parliament, IOSCO, the FSB, the Bank of England and other thought-leaders, there appears to be a growing recognition of the need for a regulatory balance and for ensuring that regulatory impediments are commensurate with the benefits they deliver; to allow responsible securitisation as an important tool for financing the real economy, but also to ensure that the next financial crisis is not a repeat of the last. Consistent with this insight, Europe's regulators are mandated[18] to keep a watchful eye on market developments and the effectiveness of existing regulation and, along with incremental development via the mechanism of the EBA's Single Rulebook, there remains a realistic possibility of significant further change in European risk retention requirements after 2014. But if early indications for the volume of transactions are accurate, and there have been predictions of up to 40 European CLO transactions in 2014, then the prospect of any significant relaxation in Europe's risk retention standards must be a distant one.

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[1] http://www.eba.europa.eu/documents/10180/209701/EBA-BS-2013-091rev2--RTS-ITS-securitisation-retention-rules-clean.pdf.

[2] When the Consultation Paper was originally published, these were numbered as Articles 393-399.

[3] http://new.eur-lex.europa.eu/legal-content/EN/TXT/?qid=1387712184909&uri=CELEX:32013R0575R(02).

[4] Milbank's previous Client Alert on the Consultation Paper can be found at http://www.milbank.com/images/content/1/3/13767/Milbank-Briefing-EBA-Public-Consultation-on-RTS-ITS.pdf.

[5] http://www.eba.europa.eu/documents/10180/106202/Guidelines.pdf.

[6] http://www.eba.europa.eu/documents/10180/16325/EBA-BS-2011-126-rev1QA-on-guidelines-Artt122a.pdf.

[7] Milbank's previous Client Alert on the Consultation Paper can be found at http://digital.milbank.com/i/133527.

[8] Article 290 of the Treaty on the Functioning of the European Union. http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2012:326:0047:0200:EN:PDF.

[9] Draft ITS, Article 1(7).

[10] See “Pre-2011 transactions with substitute exposures” in Section 4.4. (Feedback on public consultation) of the Final Drafts.

[11] Per Article 410(2) of the CRR, only Articles 405, 406, 408 and 409 of the CRR are within the scope of the Draft RTS.

[12] Per Article 4(1)(14) of the CRR, “sponsor” means an institution other than an originator institution that establishes and manages an asset-backed commercial paper programme or other securitisation scheme that purchases exposures from third-party entities.

[13] Per Article 4(1)(3) of the CRR, “institution” means a credit institution or an investment firm.

[14] See paragraph 29 in Section 4.2. (Draft cost-benefit analysis/impact assessment) of the Final Drafts.

[15] Per Sharon Bowles, Member of the European Parliament for South East England and Chair of the European Parliament's Economic and Monetary Affairs Committee, speaking on Securitisation to the AFME Conference on June 19, 2013. http://sharonbowles.org.uk/en/article/2013/700894/speech-on-securitisation-to-afme-conference-by-sharon-bowles-mep.

[16] http://www.eba.europa.eu/single-rule-book-qa#search.

[17] See Milbank’s related Client Alert at http://www.milbank.com/images/content/1/4/14848/AIP-Client-Alert-Credit-Risk-Retention-Concerning-CLOs.pdf.

[18] C.f. Articles 410(1) and 512 of the CRR.

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