Milbank

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CONTACT

James Warbey
Partner
+44-20-7615-3064
jwarbey@milbank.com

John Goldfinch
Senior Associate
+44-20-7615-3109
jgoldfinch@milbank.com

Alternative Invesments Group Client Alert: Risk Retention Reinvention: Some Questions Answered

On May 22, 2013, the European Banking Authority (the "**EBA**") published a consultation paper[1] (the "**Consultation Paper**") including draft regulatory technical standards (the "**RTS**") and implementing technical standards (the "**ITS**") in relation to the risk retention requirements set out in Articles 393-399 of the EU Capital Requirements Regulation (the "**CRR**"). The draft technical standards, which are subject to a 3-month consultation period, before finalisation and submission to the European Commission for adoption as a regulation with direct effect across the European Union from 1 January 2014[2] , re-write the existing interpretation of the risk retention framework previously published by the EBA (and its predecessor, the Committee of European Banking Supervisors ("**CEBS**")); the immediate market reaction and consensus appears to be that these changes are substantial and, for Europe's newly re-emergent CLO industry, not for the better. Indeed, although the Consultation Paper is coherent and generally well-written, it recognises that the retention requirement is likely to represent a material challenge to specific classes of securitisation transactions and may require a long term modification of the managed CLO model[3] .

In the following article, we address a number of questions on the EBA consultation and proposed technical standards as they affect Managed CLOs and, in light of our conclusions, raise a number of pertinent questions for the EBA.

Q1. REMIND ME WHAT RISK RETENTION IS ALL ABOUT?

A. In reaction to the market turmoil experienced during the financial crisis, particularly the unexpected, and large, losses in non-conforming RMBS transactions, and with a concern that securitisation had led to overly-relaxed loan underwriting standards, in April 2009 the G20 mandated[4] the Basel Committee on Banking Supervision to investigate the risk management of securitisations and consider due diligence and quantitative retention requirements. The European Commission's response was implemented by the insertion in the CRD2 legislative package[5] of a new **Article 122a** in the Banking Consolidation Directive[6]. Article 122a(1), which took effect from 1 January 2011, provided that a credit institution (i.e. a European bank) should be exposed to the credit risk of a securitisation only if the originator, sponsor or original lender retained a material net economic interest

of not less than 5 per cent (referred to in the remainder of this article as the "**risk retention requirement**"). Article 122a(10) directed CEBS to elaborate guidelines ("**Guidelines**[7]") for the convergence of supervisory practices in relation to Article 122a, which were duly published on 31 December 2010 and subsequently supplemented by the EBA in the form of a Q&A document (the "**Q&A**[8]") on 29 September 2011. Together, Article 122a, the Guidelines and the Q&A imposed a new discipline on the securitisation market, but one which was proving workable and in recent months had allowed three post-crisis CLO transactions[9] to close. The EBA has quite fairly acknowledged the praise for its workable implementation of the new risk retention rules in paragraph 17 of the impact assessment section of the Consultation Paper: "Article 122a of the CRD and the associated Guidelines have been well received and are now well embedded in current market practices."

Europe is currently in the process of implementing the Basel III proposals in the form of a directive ("**CRD IV**") and the CRR. The CRR repeats Article 122a almost verbatim, and provisions equivalent to those previously found in Article 122a(1) are now set out in **Article 394(1)** of the CRR. Articles 399(2) and (3) of the CRR directed the EBA to prepare the RTS and ITS set out in the Consultation Paper and to submit them to the European Commission by 1 January 2014.

Q2. HAS THERE BEEN ANY CHANGE IN WHO CAN ACT AS RETAINER IN RELATION TO A CLO?

A. Yes. Previously, despite some market participants (particularly those that, perhaps, saw CLO issuers as their natural competitors) questioning the validity of the approach, the EBA had recognised that in certain cases (including Managed CLOs) where the "originate to distribute" risks that the primary legislation had been intended to address were remote, a party whose interests were most optimally aligned with those of investors could fulfil the retention requirement. To reflect this, the spirit of 122a, and subject to carefully delineated controls, the EBA had, particularly in paragraphs 25 and 26 of the Guidelines, allowed (1) the asset manager of, or (2) the most subordinated investor in, a CLO to act as retainer, even where those entities were not original lenders, originators or sponsors. However, with the re-casting of the definition of "sponsor" in Article 4(43) of the CRR, the EBA is proposing to remove these derogations and, with effect from 1 January 2014 (at the earliest), only those entities that meet the strict technical definitions of "original lender", "originator" or "sponsor" will be eligible to act as retainer in a securitisation "with no exceptions".

Q3. ARE THERE ANY NEW WAYS TO SATISFY THE RETENTION REQUIREMENT?

A. Yes. During the legislative passage of the CRR, a new Article 394(1)(e) was added and is the subject of Article 9 of the RTS. Assuming it survives "legal linguistic finalisation", Article 394(1)(e) introduces a new method of satisfying the retention requirement by "retention of a first loss exposure [of] not less than 5 percent of every securitised exposure".

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

A. Probably not. Although a collateral manager should almost always have the requisite initial and continuing involvement in a Managed CLO to satisfy the "establishes and manages" criteria for sponsorship, a prospective manager also needs to qualify as an "institution" via one of the related definitions in Article 4 of the CRR (see Annex I). These definitions might initially suggest that the collateral manager could qualify as an "investment firm". However, for the purposes of Article 394 of CRR, the "investment firm" definition does not explicitly extend to undertakings established in third countries, which, were they established in the European Union, would constitute institutions – thereby eliminating non-European collateral managers. Also, although European collateral managers that are currently subject to the Markets in Financial Instruments Directive[10] ("**MiFID**") are better-placed than their non-European competitors, it appears that those that are required by the Alternative Investment Funds Managers Directive[11] to re-authorise as an AIFM will cease to be subject to the requirements of MiFID and, consequently, no longer qualify as potential "sponsors".

Q5. WHAT IS THE POSITION FOR EXISTING INVESTORS IN MANAGED CLOS AND FOR PROSPECTIVE INVESTORS IN MANAGED CLOS THAT ARE DUE TO CLOSE BEFORE 1 JANUARY 2014?

A. Article 122a(5) and Article 396 of the CRR each provide for the imposition of additional capital charges for non-compliance with the risk retention requirement. However, these penalties apply only in the case of "material" non-compliance "by reason of the negligence or omission of the [credit] institution". Accordingly, for transactions that have already closed and which were compliant with Article 122a at closing, compliance with the risk retention requirement should not be re-assessed and penalised when the CRR becomes effective. However, with publication of the Consultation Paper having now primed the market on the likely legislative environment post 1 January 2014, investors in Managed CLO deals that close after 22 May 2013 should seek to comply with Article 122a and also Article 394(1) of the CRR, interpreted, respectively in light of the Guidelines and the RTS. Where a new transaction that is compliant with Article 122a(1) becomes non-compliant with Article 394(1) of the CRR with effect from 1 January 2014, investors will otherwise be vulnerable to the accusation that they negligently failed to invest in compliance with the risk retention requirement and to the imposition of additional capital charges.

Q6. ARE PARTIES OTHER THAN INVESTORS IN SECURITISATIONS SUBJECT TO RISK RETENTION?

A. Yes. As is the case with Article 122a(1), Article 394(1) of the CRR applies whenever an institution[12] assumes exposure to the credit risk of a securitisation position. So, liquidity facility providers, hedge counterparties and other entities (including credit protection sellers) may all find their exposure is subject to the risk retention requirement. With respect to liquidity facility providers, and other than in exceptional circumstances, paragraphs 11 and 12 of the Guidelines provide that the risk retention requirement applies to a liquidity facility unless the facility meets the criteria set out in CRD2[13] for eligible liquidity facilities. These requirements in the Guidelines have now been replicated in the

RTS by reference to criteria set out in the CRR[14], but without the derogation for exceptional circumstances. The result is that it is, if anything, now more challenging for European banks to offer liquidity facilities to Managed CLOs that do not satisfy the retention requirement.

Similar concerns apply in relation to derivative counterparties, where the limited assistance previously provided by paragraph 13 of the Guidelines will now be superseded by the more concise and less helpful language in Article 3(2) of the RTS. As before, this provides that exposure to the credit risk of either securitisation positions or securitisation exposures triggers the retention requirement. However, Article 3(2) of the RTS provides no specific guidance as to when a derivative counterparty will not be exposed to such credit risk.

Q7. CAN THE RETENTION REQUIREMENT STILL BE SATISFIED ON A GROUP BASIS FOR CONSOLIDATED ENTITIES?

A. Only in very limited circumstances. Whereas, in relation to Article 122a(2), paragraph 71 of the Guidelines and Q&A paragraph 21 had provided support for assessing satisfaction of the retention requirement on a consolidated group basis, there is no equivalent provision in relation to Article 394(2) of the CRR in Article 14(1) of the RTS. Nor has the EBA seen fit to provide any insight on the proper interpretation of Article 394(2) of the CRR, which, as a sentence, does not parse easily. We are left with a situation where only those institutions in a group whose regulatory capital requirements are supervised on a consolidated basis may satisfy the retention requirements on a consolidated basis. Furthermore, given the placement of the phrase "which are included in the scope of supervision on a consolidated basis", the conservative approach would be to treat the group assessment option as only applying where all the exposures are originated by a single group – potentially limiting its application to balance sheet securitisations.

Q8. CAN A RETAINER HOLD 5% OF EACH UNDERLYING EXPOSURE TO SATISFY ARTICLE 394(1) OF THE CRR?

A. Yes as regards originators[15] and, in the case of sponsors, perhaps yes. The CRR distinguishes securitisations of revolving exposures[16] (where the balance outstanding on individual exposures fluctuates) from revolving securitisations[17] (where exposures are added to and removed from the securitisation). Previously, paragraph 48 of the Guidelines had interpreted Article 122a(1)(b) (applying to securitisations of revolving exposures) as applying equally to revolving securitisations and permitted originators (but not sponsors) to satisfy Article 122a(1) by retention of 5 percent of every underlying exposure. Although welcome, this interpretation had limited the 5 per cent. revolving exposure retention option to originators. The EBA is now proposing an alternative approach in the RTS; instead of suggesting a broad interpretation of Article 394(1)(b) of the CRR (which replaces Article 122a(1)(b)), Article 6(1)(a) of the RTS suggests that a vertical slice retention of each of the tranches sold to investors may be achieved by retaining at least 5 per cent. of the credit risk of the securitised exposures. Curiously, given that the vertical slice retention method is generally available to both sponsors and originators, Article

6(1)(a) of the RTS goes on to cite the example of a revolving securitisation and says that this "would" (not "could") occur through retention of the originator's interest. More curiously, Article 6(1)(a) of the RTS suggests that the retained credit risk must rank "at least" pari passu with the securitised credit risk which, given the normal meaning of those words and the fact that retention of a first loss position of at least 5 per cent. in every securitised exposure is addressed in Article 394(1)(e) of the CRR and in Article 9 of the RTS, suggests that a last loss retention is permitted. Since a last loss retention would hardly align the interests of the retainer and other investors, we suggest that the inclusion of the words "at least" in Article 6(1)(a) of the RTS is erroneous and that the words "at least" should either be deleted or replaced with the words "no better than".

Q9. IS THIS THE END OF THE LINE FOR EUROPEAN MANAGED CLOS?

A. Probably not. The European finance industry has a long history of innovating and adapting to meet the demands of new legislation and regulation. With Article 122a and the Guidelines, some time was required to assimilate the changes and to produce structures that complied with both the technical requirements and the spirit of the risk retention requirement. There is no reason to think that, in time, the market will not adapt to take account of the Consultation Paper and approach proposed to risk retention under the CRR. Nonetheless, it is undeniable that removal of the independent equity investor route to compliance with risk retention requirements, and other changes that restrict flexibility previously granted by the Guidelines, move the market in precisely the opposite direction to that for which the industry had been lobbying[18].

At the time of writing, 3 European Managed CLOs have closed in 2013, all prior to publication of the Consultation Paper. Market intelligence had suggested a total of 15-20 European Managed CLOs (perhaps €6 billion in principal amount) might close during 2013 (mainly relying on an independent equity investor as retainer), providing much-needed liquidity and injecting life into the somewhat dormant new-issue market for European leveraged loans. In light of the Consultation Paper, this prediction now looks overly optimistic as there is certain to be a hiatus while transactions pause to adapt to, and await finalisation of, the new regulatory environment.

It is also worth noting that, for now at least, the Consultation Paper and the CRR are somewhat at odds with recent recognition by legislators and consultative bodies of the benefits of securitisation and that a one-size-fits-all approach to securitisation may be inappropriate. In particular, a recent EU Green Paper[19] recognises that European securitisation markets are under-developed and their revival, subject to appropriate oversight and data transparency, could help unlock an additional (and much-needed) source of long-term finance for the European economy. Indeed, this sentiment is echoed by the EBA in the impact assessment section of the Consultation Paper, which recognises that "[t]he recovery of securitisation in the Single Market is expected to benefit the real economy ... and increase the availability of funding for both households and firms".

[1] http://www.eba.europa.eu/cebs/media/Publications/Consultation%20Papers/2013/CP-14/EBA-BS-2013-091rev2--RTS-ITS-securitisation-retention-rules-clean.pdf

[2] Depending on when the CRR is published in the Official Journal of the European Union, this may be postponed to 1 July 2014 (c.f. CRR, Article 488(1a)).

[3] Paragraph 23 of the impact assessment section of the Consultation Paper

[4] http://www.g20.org/load/780987058

[5] Directive 2009/111/EC

[6] Directive 2006/48/EC

[7] http://www.eba.europa.eu/cebs/media/Publications/Standards 20and 20Guidelines/2010/Application 20of 20Art. 20122a 20of 20the 20CRD/Guidelines.pdf

[8] http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2011/EBA-BS-2011-126-rev1(QA-on-guidelines-Artt122a).pdf

[9] Cairn CLO III B.V., Dryden XXVII Euro CLO 2013 B.V. and ALME Loan Funding 2013-1 Ltd.

[10] Directive 2004/39/EC.

[11] Directive 2011/61/EU.

[12] Article 122a was narrower and applied only to "credit institutions".

[13] Directive 2006/48/EC, Annex IX, Part 4, point 13.

[14] CRR, Article 250

[15] Recital 5 of the RTS provides a long-awaited definition for the term "original lender". However, as defined this appears to constitute a slightly narrowed sub-set of paragraph (a) of the "originator" definition set out in Article 4(42) of the CRR. As a result, there should be no practical circumstances when a retainer that purports to be the "original lender" could not also be categorised as the "originator". Accordingly, references to "originators" in the remainder of this article should be read as references to "originators and original lenders".

[16] Defined in Article 237(12) of the CRR.

[17] Defined in Article 237(12a) of the CRR.

[18] There had even been a small hope, following a roundtable meeting of national regulators and market participants with the EBA on 30 November 2012, that the EBA might permit funds managed by a collateral manager to act as retainer.

[19] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0150:FIN:EN:PDF

ANNEX I
SOME USEFUL DEFINITIONS:

"**credit institution**": an undertaking the business of which is to receive deposits or other repayable funds from the public and to grant credits for its own account; (CRR, Article 4(1)).

"**institution**": a credit institution or investment firm; (CRR, Article 4(4)).

"**investment firm**": institutions as defined in Article 4(1)(1) of Directive 2004/39/EC [MiFID] (being a person in the business of providing investment services) which are subject to the requirements imposed by that Directive...[subject to certain exclusions]; (CRR, Article 4(8)).

"**originator**": either of the following:

(a) an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised;

(b) an entity which purchases a third party's exposures for its own account and then securitises them; (CRR, Article 4(42)).

"**sponsor**": means an institution other than an originator institution that establishes and manages ... [a] securitisation scheme that purchases exposures from third party entities; (CRR, Article 4(43)).

ANNEX II
QUESTIONS FOR THE EBA:

1. Are the words "at least pari passu" which appear twice in Article 6(1)(a) of the RTS intended to permit retention of a last loss portion of the credit risk of each exposure?

2. With regard to Article 14 of the RTS, can you provide guidance on the proper application of the phrase "included in the scope of supervision on a consolidated basis" in Article 394(2) of the CRR. Is the phrase intended to apply (as it logically perhaps should) to a parent credit institution and its subsidiaries acting as sponsor regardless of the source of the securitised exposures, or does the phrase apply (as appears to be grammatically correct) to the institutions from which the exposures are securitised?

3. The Consultation Paper suggests (particularly paragraphs 25 and 27 of the impact assessment) that as Managed CLOs are mostly structured by investment firms, given the wider definition of "sponsor" under the CRR, those elements of flexibility introduced by the Guidelines relating to the identification of a retainer are no longer required. Is it intended, given that AIFMD will require most asset managers to re-authorise as AIFMs, that AIFMs will therefore be ineligible to act as "sponsors" of securitisations?

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NEW YORK
One Chase Manhattan Plaza, New York, NY 10005

Elizabeth Besio Hardin	ehardin@milbank.com	+1-212-530-5037
Deborah Festa	dfesta@milbank.com	+1-212-530-5540
Jay Grushkin	jgrushkin@milbank.com	+1-212-530-5346
Bruce Kayle	bkayle@milbank.com	+1-212-530-5956
Eric Moser	emoser@milbank.com	+1-212-530-5388
Albert Pisa	apisa@milbank.com	+1-212-530-5319
Blair Tyson	btyson@milbank.com	+1-212-530-5233
Andrew Walker	awalker@milbank.com	+1-212-530-5624

LOS ANGELES
601 South Figueroa Street, 30th Floor Los Angeles, CA 90017

Deborah Festa	dfesta@milbank.com	+1 213-892-4400

LONDON
10 Gresham Street London EC2V 7JD England

James Warbey	jwarbey@milbank.com	+44-20-7615-3064