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CLO Briefing: Recent European Regulatory Developments

Weil has been at the forefront of the European CLO/CDO market since its inception in 1996 and is currently involved in the structuring and creation of new CLO 2.0 transactions. Most recently, we advised GSO Capital on the issuance of the Grand Harbour 1 BV transaction. We are actively advising clients on the issues and ideas in this briefing.

Just as the European CLO market was finally beginning to take off again, recent regulatory developments have produced some turbulence. Risk retention requirements had been seen as one of the biggest challenges facing the market but the market seemed to be coming to terms with the current regime under Article 122a of the EU Capital Requirements Directive (Article 122a). However, a consultation issued by the European Banking Authority (EBA) last month indicated a shift in the regulatory position.

In contrast with the EBA consultation, the final passage of the second amendment to the EU Regulation on Credit Rating Agencies under the reform package known as "CRA 3" has not attracted big headlines. Nevertheless it is worth noting certain aspects of the provisions on double credit ratings and disclosure in relation to structured finance transactions.

In this briefing, we explore various issues raised by the new risk retention regime and consider aspects of the potential for change or clarification in relation to the points of concern. We also outline briefly the CRA 3 aspects mentioned.

Risk Retention

Under the forthcoming package of measures known as "CRD IV", Article 122a is to be replaced with provisions of a new Capital Requirements Regulation (CRR). The proposed draft CRR was politically agreed at the end of March 2013 and is intended to come into force on 1 January 2014.

While the CRR largely adopts the wording of Article 122a, there have been some small but significant changes. These variations were amplified in the consultation (Consultation) issued by the EBA on 22 May 2013 regarding proposed regulatory technical standards (RTS) in relation to risk retention. The Consultation also includes implementing technical standards in relation to additional risk weights to be applied where the risk retention and related obligations have not been complied with.

Up to that point, the prevailing retention requirements under Article 122a were informed by extensive guidelines (Guidelines) published by the Committee of European Banking Supervisors (the forerunner to the EBA) in December 2010, further expanded upon by a related Q&A report (Q&A) issued by the EBA in September 2011. Notably, the RTS will replace the Guidelines and the related Q&A.

The changes heralded by the Consultation have a wide reaching effect on the CLO market, which has relied heavily on the Guidelines & Q&A in recent transactions that have come to market in 2013. As has been found on other post-financial crisis legislative proposals, some of the changes appear to be inconsistent or unclear; it is often hard to discern if some of their effects are intentional.

Identity of retention holder

The main development that has caused ripples in the market is a shift in who is able to act as the retention holder on a managed CLO. Based on the flexibility offered by the Guidelines & Q&A, some of the new and proposed CLO 2.0 transactions contemplated the use of a third party equity investor to meet the retention requirements but it appears that the forthcoming regulatory environment will not cater for this method of retention.

In summary, Article 122a allows EU credit institutions to take exposure to the credit risk of a securitisation only if the "originator, sponsor or original lender" has explicitly disclosed to the institution that it has retained a material net economic interest of not less than 5% through one of four prescribed options. This causes difficulties in the context of managed CLOs in that frequently there is no entity that fits any of those roles. First, loan assets may be acquired from several sources, including directly by the CLO issuer after the closing of the CLO transaction, such that the collateral manager will not fit within the definitions of "originator" or "original lender". Second, while the collateral manager could conceivably be the entity which "establishes and manages" the transaction as envisaged by the definition of "sponsor", the definition applicable to Article 122a also envisages such entity being an EU regulated credit institution and collateral managers are typically not such institutions.

Helpfully, the Guidelines contemplated the possibility of a party whose interests were most optimally aligned with investors being able to fulfil the role, and specifically acknowledged a non-credit institution collateral manager and a subordinated investor as examples of such party.

The approach taken by the Consultation has moved away from this. The Consultation states that as the definition of "sponsor" has been extended in the CRR to specifically include "investment firms", (which includes asset managers regulated under the Markets In Financial Instruments Directive (MIFID)), the "legal identification" problem for managed CLOs described in the paragraph above is solved. Along with the superseding of the Guidelines and the Q&A, the commentary to Article 4 of the RTS stresses that only the "originator", "sponsor" or "original lender" as defined under the new provisions can be the retaining entity, "with no exceptions".

This change in position is thus clearly deliberate. It is not known for certain whether this is as a result of a change in policy or for technical reasons. The emphasis the Consultation places on legal certainty and "flexibility which is appropriate for directly applicable technical standards" may be an indication on the part of the EBA that it must only operate within what it sees as the scope of the Level 1 regulation now embodied in the CRR. This suggests a technical aspect to the shift, but several market participants believe this is underpinned by policy considerations.

The inability to use a third party investor as retention holder will of course cut down flexibility for the market, especially as many collateral managers at present lack the capital resources to act a retention holder for transactions. This potential effect has been acknowledged by the EBA in a much quoted sentence of the impact assessment (Impact Assessment) section of the Consultation, "This could potentially translate in the long term to a modification of the currently existing managed CLO model".

The focus there was the issue of availability of capital. Yet even if a collateral manager is willing and able to fund the retention, there is first the question of whether the "legal identification problem" has truly been solved, i.e. whether a typical CLO collateral manager meets the definition of a "sponsor". For example, while the definition of "investment firm" picks up MIFID regulated asset managers, it excludes MIFID firms not authorised to undertake certain services and which are not allowed to hold client monies. In addition, the definition of "investment firm" does not expressly include non-EU asset managers.

Further, EU alternative asset managers authorised under the Alternative Investment Fund Managers Directive (AIFMD) do not fall within the definition of "investment firm". We expect many collateral managers currently regulated under MIFID will be obliged to be re-authorised under AIFMD in July 2013 and, in so doing, will cease to be regulated under MIFID (a firm is not permitted to hold both authorisations). It is unhelpful that this eventuality was not catered for - if the regulator's concern was to ensure sponsors were within the scope of EU financial regulation, this concern would equally be met if the relevant collateral manager was authorised under AIFMD.

These issues were perhaps not fully appreciated by the EBA. We note that in paragraph 25 of the Impact Assessment, the EBA suggests that "the entity structuring the CLO ...is <u>in most cases</u> ... an investment firm subject to MIFID provisions" (our emphasis). There is no recognition that this position may be about to change. On that basis, we hope that the EBA would be receptive to the concerns of market participants in this regard. Ideally, the EBA would then be prepared to resolve the situation by means of the RTS or through guidance, although we are mindful that the relevant definitions are embedded in the Level 1 text of the CRR. If the EBA does not feel it is empowered to make this correction for technical reasons, a change of primary legislation would be needed, which would be more challenging.

Holding of retention within consolidated group

The issue above is aggravated by the apparent removal of other helpful elements of the Guidelines and Q&A relating to the provision now contained in Article 394(2) of the CRR (formerly Article 122a(2)). Article 394(2) is not easy to follow but it contemplates satisfaction of the retention requirement on a consolidated basis only by entities acting as originator or sponsor which are the subject of consolidated supervision. In what appears to be an additional condition, this ability is stated as being available only where "exposures from several credit institutions, investment firms or other financial institutions which are included in the scope of supervision on a consolidated basis" are securitised.

Separately, the first limb of the definition of "originator" both in the CRR and as used in Article 122a envisages use of other group entities, in that it includes "related entities" involved in the creation of the assets without it being specified that such entities need to be within the scope of the relevant regulation. Paragraph 71 of the Guidelines purported that such "related entities" did not need to be credit institutions.

Building on this and based on the flexibility then offered to collateral managers, paragraph 21 of the Q&A appeared to imply that the retention requirement could be met by a parent or affiliate consolidated within the accounting group of a collateral manager rather than within its regulatory capital group (given many asset managers may have the benefit of waivers from the CRD consolidation requirements).

The removal of the Guidelines and the Q&A mean that the literal provisions of Article 394(2) will hold sway, but Article 394(2) is not entirely clear on its face. Unless and until clarification (or, if appropriate, adjustment) is forthcoming from the relevant authorities, there is a concern that satisfying the retention requirement on a consolidated rather than solo basis may be confined to entities under regulatory capital supervision and to assets sourced from entities under regulatory capital supervision on a consolidated basis. We note that Article 394(2) is not explicitly mentioned in the RTS (other than in relation to a retention holder leaving the group) and is not the subject of a question from the EBA so there is a less of a defined route in which to pursue the issue.

Methods of holding retention

The retention of a net economic interest was specified as being achieved under Article 122a through one of four prescribed methods. One of the most visible changes in text between Article 122a and the equivalent CRR provisions is the addition of a fifth method of satisfying the retention requirement. New option (e) provides for the retention of a first loss exposure at the level of every securitised exposure.

In addition, the RTS alters the treatment of revolving securitisations (as distinct from revolving assets). Essentially retention for revolving securitisations moves from option (b) which in Article 122a concerns revolving exposures, to option (a) the vertical slice retention method, whereas paragraph 48 of the Guidelines had previously allowed revolving securitisations to be included within option (b). While option (a) mandates vertical slice retentions of the tranches sold to investors (i.e. the liabilities of the securitisation issuer), Article 6 of the RTS deems this requirement as being met by a retention of at least 5% of the credit risk of the securitised exposures[1] (i.e. the assets of the securitisation issuer). We speculate that the EBA may in hindsight have found it hard to rationalise the covering of revolving securitisations under option (b) because the wording of option (b) very plainly specifies only revolving assets; the EBA seems instead to have been able to fit them within option (a) by equating economic effects of the retention of percentage interests in the assets with vertical slices of the liabilities.

A managed CLO would be expected to be considered to be a revolving securitisation as it would generally feature the reinvestment of principal receipts and substitution of assets during a revolving period. As such, market professionals are considering the possibility of

[1]*Provided the credit risk retained ranks "at least pari passu" with the securitised exposures. This does not make sense as it appears to allow the retention of risk ranking senior to the securitised exposures; it would have been more logical if words to the effect of "pari passu or subordinate to" were used.*

structures based on retention of the requisite proportion of assets which may allow a transaction to avail of option (a).

There is a further obstacle however, which stems from the way the RTS is worded. Option (a) is available to originators, sponsors and original lenders, Article 6 of the RTS tracks language formerly applied to option (b), and option (b) can only be achieved by retention of the originator's interest in the securitised exposures. Thus, Article 6 requires satisfaction to occur "through retention of the originator's interest" where revolving securitisations are concerned. This appears to permit only originators to use the retention of interest in revolving securitisation exposures. If that is the case, option (a) would only be available to a CLO transaction in relation to balance sheet CLOs.

This is not entirely free from doubt as the wording of Article 6 is not abundantly clear (see also footnote 1). There is an argument against this option being available only to originators in that this may run contrary to the overall thrust of option (a), which permits retention by any of the originator, sponsor or original lender. That said, looking back to the Guidelines, this limitation could perhaps be said to have always been intended. Although paragraph 48 of the Guidelines contains a broad third sentence referring to originator, sponsor or original lender, it was couched within the parameters of option (b) which was specific to originators.

As the wording is contained in the RTS, there may be an opportunity to pursue a clarification. The Consultation does invite responses on the impact of the withdrawal of paragraph 48 of the Guidelines and the EBA has expressly asked in the Consultation whether there are "other ways to comply with the retention options set out in Article 394 … which should be included" in the RTS.

Prohibition on hedging or sale of retention

Article 122a(1) states that the "net economic interest" retained "shall not be subject to any credit risk mitigation or any short positions or any other hedge". Paragraph 27 of the Guidelines had interpreted this to extend to sales of the retained interest. Under Article 394(1) of the CRR, this position has now been explicitly adopted in the Level 1 text. Interestingly, although this was not addressed in the Guidelines or Q&A, in relation to the prohibition Article 12(2) of the RTS now specifically clarifies that the retention holder can use the retained interest "as collateral for secured funding purposes as long as such use does not transfer the credit risk" to a third party.

Multiple capacities of Retention Holders/Multiple Retention Holders

On some securitisations, it is possible for a transaction party to fit more than one of the roles of "originator", "sponsor" or "original lender". For example, in the context of a balance sheet CLO, taking the definition of each capacity separately, the relevant bank could meet the definition of original lender, originator or sponsor. However, the definition of "sponsor" excludes originators, which suggests that the same party cannot fulfil both of those roles.

A further point to note in this regard relates to the requirement for a retention holder who is a credit institution (or, under the CRR, also an investment firm) to make certain disclosures to investors about the retention. Article 22 of the RTS introduces a new obligation, namely that the retention holder must confirm whether it retains as originator, sponsor or original lender. This further amplifies that entities which fit within more than one of the roles will now need to select the basis on which they will act. This has implications in relation to other risk retention provisions of the CRR since, as discussed above, some provisions may apply only in relation to specified roles.

There can also be more than one party performing each such role. Thus, in the case of a balance sheet CLO, to the extent the CLO vehicle also acquires assets independently of that bank, there will be more than one "originator". In the case of managed CLOs, there will almost always be more than one "originator".

Article 4(2) of the RTS requires that the retention shall be fulfilled by each originator in proportion to the exposures for which it is the originator. Likewise, if there is more than one sponsor, the retention is to be fulfilled on a pro rata basis to the exposures for which it is the sponsor. While the wording of Article 4(2) broadly reflects paragraph 29 of the Guidelines, the Q&A provided specifically in relation to managed CLOs that a single originator/sponsor could be the retention holder if it provided the majority of the portfolio in the transaction. The latter guidance recognised that the legislative provisions did not make sense in the context of the way managed CLOs worked. Thus, where there can be deemed to be more than one sponsor and/or originator, the withdrawal of the Q&A means more parties need to be found to act as retention holders.

Effect on transactions closed prior to implementation of the CRR

A number of CLO 2.0 transactions priced and/or closed in 2013 before the Consultation was published and have been structured with the pre-existing Article 122a requirements and guidance in mind. To the extent they featured a third party investor as retention holder, this seems at odds with the CRR and RTS in their current form. Neither the CRR nor the RTS however envisage any grandfathering in relation to transactions completed before the implementation date of the CRR. One would have expected existing transactions to have been addressed in the regulatory materials if relief had been intended by the authorities. That said, the Consultation does request information about the extent securitisations have relied on the Guidelines and it may be their view has not yet been formed.

Additional risk weights are mandated for investors who have not met the retention requirements by reason of negligence or omission on the part of the investor. If existing transactions are not compliant with the new regulations, it would seem unreasonable to impose penalties where the transactions were completed in accordance with the legislation and guidelines prevailing at the time and the investment was made prior to the date of the Consultation. Nevertheless it is hard to predict how the competent authorities would approach the holdings in practice, particularly in the light of the fact that regulated entities are required to regularly review their exposures.

The position of any new investors in such existing transactions who are subject to regulatory capital supervision may be even less comfortable even where they have the benefit of the covenants of a retention holder under a retention letter (as has become the market norm on the European CLO 2.0 deals issued to date). At the very least, once the CRR is in effect, it would seem unwise to expect the competent authorities to take a benign view. The situation is not ideal as the secondary market value, liquidity and tradability of the relevant CLO bonds are likely to be affected.

This matter will certainly be raised by market participants in the consultation process but without any indication of comfort in this regard, it is prudent to assume (at least for the time being) that transactions prior to the effective date of the CRR will not be grandfathered. In relation to transactions which may take place in 2013 after the publication of the Consultation, the participants are now on notice of the new regime and proceeding on the old basis must be at risk of being treated as "negligence or omission". We would therefore anticipate forthcoming CLO transactions to be structured in order to comply squarely with the anticipated new regime, or else be targeted at investors who are not subject to the EU capital requirements and who are not concerned about a resulting lack of liquidity in the lead-up to, and following implementation of, the CRR.

CRA 3

Another recent regulatory development affecting CLOs was the publication of the CRA 3 regulation in the Official Journal on 31 May 2013, which means the regulations will enter into force on 20 June 2013. The content of CRA 3 is not itself big news as the substantive wording of CRA 3 was agreed at the end of last year and the text of the provisions has been known for some time. However, market participants need be cognisant of the provisions and the fact that they are about to come into effect.

Certain aspects of CRA 3 were the subject of a great deal of attention, such as the requirement for the rotation of rating agencies on securitisations. Less debated was the requirement for double credit ratings on every securitisation.

Article 8c of CRA 3 provides that "where an issuer or a related third party intends to solicit a credit rating of a structured finance instrument, it shall appoint at least two credit rating agencies to provide credit ratings independently of each other". On the face of it therefore, securitisation transactions structured after 20 June should have at least two ratings for each rated tranche in the capital structure. That said, there is no guidance as to how the wording "intends to solicit" is to be interpreted and there is room for discussion about the exact point of time in the cycle of a transaction that the obligation takes effect (for example, whether at the mandate, structuring, warehousing, launch, pricing or closing stages).

Another provision affecting structured finance instruments is the disclosure requirement now contained in Article 8b of CRA 3. This has significant implications for the market because it imposes obligations on the issuer, originator and sponsor of an

EU structured finance instrument to jointly publish detailed information about the transaction and assets via a new public webpage to be set up and run by the European Securities and Markets Authority (ESMA). The problem with this obligation is that it overlaps with other disclosure requirements under the CRR and central bank collateral eligibility requirements in relation to loan-level data but does not incorporate any of the exceptions or existing guidance applicable to those other disclosure regimes.

In addition, the drafting of the Article means that the regulation applies to every EU securitisation transaction, whether or not the transaction is rated. As has been noted elsewhere, this is a strange result if one considers that the provision is contained in legislation about credit ratings, and will likely cause difficulties for issuers of private transactions.

While Article 8b is about to enter into force, in practice secondary rules will be necessary for its implementation. ESMA is tasked with establishing the details of the information to be disclosed as well as the content and format of the data reporting and will be working on this over the next year. Until these details are finalised, market participants will not be in a position to fulfil the disclosure obligation. Given the illogical and burdensome potential effects of Article 8b, there will be a concerted market effort to seek a more balanced approach from the authorities but at this stage it is hard to predict how these issues might play out.

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