

Summary of the EU's new risk retention rules as they relate to Collateralised Loan Obligations

The new capital requirements regulation (**CRR**)¹ of the European Union (**EU**) and the accompanying directive² became effective on 1 January 2014. With their recent publication in the Official Journal, the related Regulatory Technical Standards (**RTS**) will come into effect on 3 July 2014 (together with the CRR, the **CRR risk retention rules**).

The CRR risk retention rules apply to European Economic Area (**EEA**) institutions (namely credit institutions and investment firms) and certain consolidated group affiliates thereof (including affiliates based outside the EEA)(each, an **affected CRR investor**). Similar risk retention rules (together with the CRR risk retention rules, the **EU risk retention rules**) will apply to EU insurance companies via Solvency II³ and alternative investment funds via AIFMD⁴ (together with the affected CRR investors, **affected investors**).

New Rules

Under the new rules, Articles 404-410 of the CRR replace Article 122a of the Banking Consolidation Directive. The key terms of Articles 404-410 include:

- Retained Interest (Article 405). The CRR prohibits an institution, other than when acting as an originator, a sponsor or original lender, from becoming exposed to the credit risk of a securitization position unless the originator, sponsor or original lender has explicitly disclosed to the institution that it will retain, on an on-going basis, a material net economic interest which, in any event, shall not be less than 5%. The CRR specifies that the retained interest must be one of the following:
 - retention of no less than 5% of the nominal value of each of the tranches sold or transferred to the investors (the so-called “vertical slice” approach);
 - in the case of securitizations of revolving exposures, retention of the originator’s interest of no less than 5% of the nominal value of the securitized exposures;
 - retention of randomly selected exposures, equivalent to no less than 5% of the nominal value of the securitized exposures, where such exposures would otherwise have been securitized in the securitization, provided that the number of potentially securitized exposures is no less than 100 at origination;

¹ [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.

² [Directive 2013/36/EU](#) of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

³ [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. The risk retention rules under Solvency II are expected to come into effect from January 2016 at the earliest.

⁴ [Directive 2011/61/EU](#) 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. The risk retention rules under AIFMD will come into effect by no later than 22 July 2014.

- retention of the first loss tranche and, if necessary, other tranches having the same or a more severe risk profile than those transferred or sold to investors and not maturing any earlier than those transferred or sold to investors, so that the retention equals in total no less than 5% of the nominal value of the securitized exposures (the “first loss” approach); and
- retention of a first loss exposure of not less than 5% of every securitized exposure in the securitization.

The CRR specifies that the net economic interest is measured at origination and shall be maintained on an on-going basis, that the net economic interest, including retained positions, interest or exposures, must not be subject to any credit risk mitigation or any short positions or any other hedge and must not be sold, and that the net economic interest is determined by the notional value for off-balance sheet items.

- Due Diligence (Article 406). The CRR specifies that an institution, before becoming exposed to the credit risk of a securitization and as appropriate thereafter, must demonstrate to the competent authorities for each of its individual securitization positions that it has a comprehensive and thorough understanding of and has implemented formal policies and procedures commensurate with the risk profile of its investments in securitized positions.
- Additional risk weight (Article 407). The CRR provides that, where an institution does not meet the requirements in Article 405 (which is new), 406 or 409 in any material respect by reason of the negligence or omission of the institution, the competent authorities must impose a proportionate additional risk weight of no less than 250% of the risk weight (capped at 1250%).
- Criteria for credit granting (Article 408). The CRR provides that sponsor and originator institutions must apply the same sound and well-defined criteria for granting credit to exposures to be securitized as they apply to exposures to be held in their own books.
- Disclosure to investors (Article 409). The CRR provides that institutions acting as an originator, a sponsor or original lender shall disclose to investors the level of their commitment under Article 405 to maintain a net economic interest in the securitization, and provide prospective investors with readily available access to all materially relevant data on the credit quality and performance of the individual underlying exposures, cash flows and collateral supporting a securitization exposure as well as such information that is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures.

The key terms of the RTS relating to risk retention for CLOs include:

- The retained interest may be met on a synthetic basis, including by way of a guarantee, a letter of credit or a similar form of credit support, as long as the amount retained is at least equal to the required retention amount and the retention holder discloses its commitment to hold the retention on an on-going basis, the details of the retention, and its equivalence to one of the retention options.
- If the retained interest is met on a synthetic basis by a retention holder other than a credit institution, it must be fully collateralised in cash held in a segregated account. Given that most CLO collateral managers are not credit institutions, this cash collateralisation requirement will apply to them should they wish to provide the retention synthetically.
- The calculation of the retention is based on the nominal values, and not the purchase prices, of the relevant exposures.

- Overcollateralisation is a form of credit enhancement that can satisfy the 5% retention requirement.
- Excess spread does not count toward the amount of the retained interest.
- The retained interest may not be split among different types of retention holder.
- The retention holder is not constantly required to replenish the retained interest to 5%. There may not be an embedded mechanism by which the retained interest declines faster than the interests transferred to investors, but otherwise it is permissible for the retained interest to reduce via cash flow allocations over time.
- The prohibition in Article 405 on subjecting the retained net economic interest to any credit risk mitigation, short positions, other hedge or sale shall be applied “in the light of the purpose of the retention requirement and taking account of the economic substance of the transaction as a whole”. This provision suggests that a transfer of the retained interest from a resigning asset manager to the new asset manager is permitted, because such a transfer retains the alignment of decision-making and funds at risk.
- Institutions must review their compliance at least annually and more frequently if the institution becomes aware of a material change in the risk characteristics of the securitization position or the underlying exposures, or in any structural feature that could materially impact performance of the securitization position.
- The retained interest may be provided as collateral to support third party financing of the retained interest, provided that the retention holder does not thereby transfer the credit risk of the retained interest to the finance provider. As a result, some CLO retention holders are acquiring a retained interest in the form of a vertical slice rather than a first loss exposure in order to maximise the amount of third party funding available.

Although the old rules permitted the retained interest to be held by any entity within the consolidated accounting group of the retention holder, the new rules limit retention on a consolidated basis only for groups headed by an EU parent credit institution, an EU financial holding company or an EU mixed financial holding company.

Grandfathering

Given the rule-changes reflected in the CRR, affected investors rightly want to know whether, without attracting additional capital charges, they can continue to hold transactions (**old rules transactions**) that qualified under the rules in place prior to 1 January 2014 but that do not qualify under the new rules. The CRR text provides that the new risk retention rules take effect from 1 January 2011 and, after 31 December 2014, applies to securitizations created prior to 1 January 2011 where new underlying exposures are added or substituted after that date.

For old rules transactions, the apparent outcome is that affected investors which invested prior to the CRR effective date will be allowed to continue to hold those exposures without increased capital charges, but that affected investors acquiring exposure after 1 January 2014 (even a position issued prior to that date) would be subject to increased capital charges unless the position qualifies under the new rules.

As a result, old rules transactions may become somewhat less liquid. The extent of the reduction in liquidity and its effect on pricing, however, is unclear. The pricing of CLO transactions issued as “non-compliant” transactions indicates that the impact on pricing may be minor. Moreover, the

illiquidity premium for non-compliant deals may reduce over time as more transactions – both compliant and non-compliant – are issued and the CLO investor base grows.

Affected investors will also want to know whether CLO transactions launched prior to 1 January 2011 will become subject to the EU risk retention rules should any replenishment occur after 31 December 2014 (including as a result of reinvesting unscheduled principal proceeds or the proceeds of credit impaired obligations or credit improved obligations). It appears⁵ that CLO transactions will not become subject to the EU risk retention rules by virtue of replenishment occurring after 31 December 2014 in accordance with terms explicitly set out in the original CLO documents.

⁵ The RTS endorses all background information in the final draft RTS delivered by the European Banking Authority (**EBA**) to the European Commission. In its final draft RTS, the EBA background information provides that, *inter alia*, the guidance under the prior risk retention rules will remain relevant regarding how to interpret the substitution of exposures for securitization transactions launched before 1 January 2011. That guidance (and the related Q&A) provides with respect to CLOs that replenishment after 31 December 2014 will not trigger application of the EU risk retention rules if conducted according to terms “specifically pre-defined in the contractual terms of the transaction.”