Feature

KEY POINTS

- It is hoped that the European Commission will take a pragmatic approach that maintains the status quo of flexibility, permitting the originator or sponsor to fulfil the key direct obligations (risk retention, transparency requirements, credit-granting), whether based in the EU or not.
- Although the key requirements of the SFDR have not been on-shored into English law, the SFDR remains relevant for UK and other third country firms in certain circumstances.
- Increased obligor and loan arranger co-operation – whether by way of direct regulation, changes in market practice or indirect pressure from the collateral managers of CLOs which buy the debt – may encourage collateral managers to provide their investors with contractual comfort and transparency around sustainability factors in their investment process.

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Passing regulatory headwinds for a flourishing European CLO market

In this article the author considers how the CLO market is grappling with an ever-evolving regulatory environment.

2020 was a relatively slow year for what had been a booming CLO market, with the initial stages of the pandemic resulting in a short-term dip in perceived corporate debt value and a reluctance of investors to deploy capital ahead of the implementation of state-led recovery packages. 2021 has been starkly different, with issuance volumes in the European CLO market set to potentially match or exceed those achieved in 2018 and 2019.[1] Whilst the market flourishes, behind the scenes market participants have had to grapple with an ever-evolving regulatory environment. In particular, sell-side market participants must determine how to adapt and evolve to achieve the best overall results for their investors across the capital structure, many of whom are placing increased emphasis on more sustainable investment strategies. A few of the key current topics are considered herein.

RISK RETENTION HOLDER CAPACITY AND SUBSTANCE AND THE SOLE PURPOSE TEST

The UK and EU Securitisation Regulations each place a direct responsibility on an in-scope originator or sponsor of a UK or European CLO to hold a 5% material net economic interest in such transaction until its final maturity.[2] Alongside this, certain European and UK institutional investors are required to perform due diligence before investing in a CLO to ensure that, amongst other things, a qualifying sponsor or originator has committed to retain the aforementioned material net economic interest.[3]

Historically, the majority of CLO collateral managers in the European CLO market (including UK firms prior to the withdrawal of the UK from the EU) sought to rely on the sponsor retention capacity, which – until the advent of the revised securitisation regulatory regime in 2019[4] – explicitly permitted an EU investment firm with certain specific regulatory authorisations to fill this capacity. Despite the hopes of third country collateral managers (now including those based in the UK) that the EU Securitisation Regulation would enable non-EU investment firms regulated in their home jurisdiction to fulfil the sponsor capacity, no clear position came about.[5]

As a result, third country collateral managers now rely exclusively on the "originator" retention capacity for their transactions. A retention holder that is also the collateral manager can qualify as a valid retention holder by holding the credit risk on a portion of the CLO portfolio prior to the CLO issuance.[6]

A now common alternative model to the collateral manager holding the retention is to establish a debt investment company, which may be capitalised by internal capital from the collateral manager and its corporate group and/or external investor capital. To ensure the debt investment company is a retainer whose interests are aligned with those of the investors, this entity is required to establish the CLO, provide the majority of the assets of the CLO from its investment portfolio and, importantly, have sufficient substance.

The Securitisation Regulations make clear that the originator retainer cannot be established or operate on an on-going basis purely as an entity which purchases assets and then transfers them to the CLO, with no other function or business beyond this.[7] Further granular guidance on what should be taken into account to demonstrate sufficient substance and business function beyond merely acting in a capacity as retention holder has been in development for over two years now.[8] The latest draft of the technical standards related to risk retention produced by the European Banking Authority (EBA) seeks to set out some of the guiding principles, such as:

- the entity having the capacity to meet its payment obligations from income and capital beyond the income from the retention notes and the assets it has ear-marked for transfer to the CLO; and
- the entity's decision-makers having the requisite experience to pursue its business strategy.

Whilst these draft technical standards are not yet finalised, there is a clear emphasis on the need for:

a) a proportion of the originator's asset portfolio over time to consist of non-retention assets, which may include individual loan and bond asset investments, investments in other income strategies or un-deployed cash holdings;

b) the entity to have income streams beyond the retention assets, which may include income streams from the assets and investments mentioned in (a) above, fee streams from advisory, management or origination roles and/or capital available to meet the liabilities of the entity from time to time, which could consist of shareholder capital or raised debt capital; and
c) the entity's decision-makers, such as the board of directors or those who have oversight of the executive function of the entity, to have technical knowledge and experience of the credit market to ensure the supervisory role is one of substance, rather than a rubber-stamping of a decision made by an external advisor or manager.

These are important considerations for participants looking to establish or maintain compliant originators in the current regulatory environment.

NEW HEADWINDS RELATED TO THE DIRECT SCOPE OF THE RISK RETENTION AND TRANSPARENCY OBLIGATIONS

To date, CLO market participants have typically selected the party perceived to be the most appropriate to fulfil the key direct obligations of the Securitisation Regulations.[9] On 25 March 2021, the European Supervisory Authorities (ESAs)[10] published an opinion relating to the jurisdictional scope of application of the EU Securitisation Regulation[11] (the ESAs' Opinion). On a positive note, especially for US CLO market participants, the ESAs' Opinion affirms the current market understanding that where the originator, sponsor and securitisation special purpose entity (SSPE) are all located outside of the EU, there are no Direct Obligations on those parties.[12]

Other aspects of the ESAs' Opinion have raised concern that, notwithstanding that third country entities should be able to be transaction parties to a securitisation, if one or more of the originator, sponsor or SSPE of the CLO are established in the EU, the ESAs consider that one of the parties established in the EU should be directly responsible for the Direct Obligations as opposed to a third country entity.[13] The ESAs argue that third country entities, which fall outside of EU regulatory supervision, are unable to be effectively supervised and held accountable.

This is an unfortunate potential change in position for the CLO market, which has focussed, within the spirit of the EU Securitisation Regulation retention requirements, on the alignment of interest of the retention holder with that of the CLO investors. Mandatorily placing the risk retention obligation on one of the parties located in the EU may result in a situation where the retainer is not the party with the most alignment with investors, ie the EU entity may formally qualify as a valid retainer, but another potential transaction party may have more involvement or interest in the transaction. Further, placing the transparency and credit-granting due diligence obligations on a party located in the EU may not make sense from a commercial perspective, as the EU party may not always have access to the information required to fulfil the obligations.

In practice, due to the need for EU institutional investors to fulfil their due diligence obligations related to the Direct Obligations,[14] the designated risk retainer and reporting entity on a CLO will be bound by contractual covenants to fulfil such obligations, often backed by indemnity coverage related to breaches. Therefore the concerns of the ESAs, which focus on adequate supervision for the protection of EU CLO investors, seem unfounded. Furthermore, the ESAs' recommended approach could result in the need for CLO participants to consider a restructuring of their transactions (if the European Commission adopts the recommendations and no grandfathering of existing transactions is provided for) or, in respect of new transactions, an alternative structural approach to avoid the need for an unintended transaction party to be subject to the Direct Obligations.

Whilst the ESAs' Opinion is not binding guidance, it is hoped that the Commission, as part of its consultation with the market on the issues raised by the ESAs,[15] will take a pragmatic approach that maintains the status quo of flexibility around which party can fulfil the Direct Obligations. In the author's view, this would provide for the best alignment of interest between the retainer and the CLO investors.

ESG AND SUSTAINABILITY APPROACHES AND ISSUES

CLO investors continue to focus on environmental, social, governance (ESG) and sustainability considerations related to their investments. In the asset management space, this focus is no longer exclusively on the creation of specialist investment products which are marketed on the basis of their compliance with ESG and sustainability factors. Instead, managers across the board (whether or not they are directly bound by regulatory rules around the subject) are increasingly under pressure to adapt their investment strategies to take account of ESG and sustainability factors in their decision-making processes. Emphasis on sustainable securitisation is also mandated into the European regulatory pipeline,[16] with the EBA currently consulting on a potential framework for sustainability securitisations, which will likely catch European CLOs.

Whilst CLOs do contain asset diversity controls via maximum industry exposure limits, the ability to invest across a full spectrum of industries is relatively uninhibited. But almost across the board, collateral managers now include negative screening ESG eligibility criteria in their transactions to prevent investment in certain industries perceived to be harmful (such as weapons manufacturing and the manufacturing of hazardous substances and chemicals), in some cases also excluding obligors who do not comply with the United Nations Global Compact Ten Principles.[17]

A few recent transactions go further and consider certain ESG factors both at the initial purchase of an asset and on an on-going basis.[18] Assets are graded on their level of positive ESG adherence, and the collateral manager is required to maintain a weighted average ESG score across the portfolio, which is reported periodically to investors.

Where it is determined that an asset in the portfolio no longer complies with the deal's ESG criteria, the collateral manager is required to determine a course of action with a view to restoring such compliance, which might include consultations with the obligor or selling the asset.

Certain of the above-mentioned requirements are driven by investors at the marketing stage of the CLO. However, the focus on these factors now stems not just from a change in investor ethos, but also the recent EU imposition of transparency and reporting standards under the Sustainable Finance Disclosure Regulation (SFDR).[19] The SFDR requires that "financial market participants",[20] when marketing a "financial product",[21] ensure they have published sustainability risk policies[22] and are transparent on how they consider sustainability factors in their investment decision-making processes.[23] When market participants assess sustainability impacts, they must publish and maintain on their website a Principal Adverse Sustainability Impacts Statement (PASIS). Once the SFDR "Level 2" technical standards take effect in July 2022, the PASIS will need to contain a mandated set of information on a variety of sustainability indicators, the exact detail of which is yet to be mandated.[24]

CLO issuers are not perceived to be SFDR "financial market participants", as they are not regulated advisors or managers. In addition, the UK's withdrawal from the EU took place before the effective date of the key requirements of the SFDR. As such, the key requirements have not been on-shored into English law. This means UK established collateral managers are not yet subject to equivalent requirements. The considerations around the SFDR currently tend to apply only to EU collateral managers in respect of their direct relationship with the CLO issuer.[25] However, the SFDR remains relevant for UK and other third country firms in certain circumstances. In particular, the Commission has clarified[26] that, on the basis that the definition of a financial market participant includes the term "alternative investment fund manager" (AIFM) and as the term encompasses both EU and non-EU AIFMs,[27] the scope of the SFDR includes non-EU AIFMs when they market into Europe. While there is a strong argument that this interpretation means only the product-level requirements apply under the SFDR (not the entity-level requirements), in the absence of further clarity from the Commission, some may take a different view.

However, CLO investors are often investment vehicles, such as pension funds, UCITS or AIFs which are established or managed by entities falling within scope of the "financial market participant" definition, therefore applying certain of the SFDR requirements in relation to the participant, including in respect of any CLO investments the investment vehicle makes. As a result, an in-scope investor or its manager will place pressure on the CLO collateral manager to ensure the provision of the requisite transparency and reporting on sustainability matters.

The portfolios of European CLOs comprise debt obligations issued by large corporate obligors, which the collateral manager has the ability to switch from time to time. When deciding on the initial portfolio or the reinvested assets of the CLO, the collateral manager will undertake a process of due diligence on the underlying obligor of the asset to assess its credit quality and its ability to meet the legal and technical eligibility criteria of the CLO.

When it comes to transparency around the CLO's investments, the collateral manager will, as part of its due diligence process, rely almost exclusively on publicly available information or information provided by the underlying obligor. Many large corporate obligors, particularly those with listed debt or shares, are required to produce publicly available information regarding how they earn their revenue. For private companies, the collateral manager will be more reliant on information they receive directly from the obligor, which may be significantly more limited.

Herein lies the problem for a CLO collateral manager: how do you agree to contractual obligations to report certain data or effectively install sustainability and ESG factors into your investment process if the quality and availability of information is deficient. The majority of the assets of the CLO are likely to be purchased in the secondary market, where the ability to have an open and detailed discussion with the obligor about its business and revenue sources may be limited. For example, information may be limited to a marketing presentation which does not follow a prescribed form. Even if the loan is being purchased as part of a primary syndication, access to information may depend on bargaining power relative to other lenders. This reality directly conflicts with the need to access a significant level of information about the obligor's adherence to sustainability principles. As such, collateral managers may be reluctant to agree to report in a similar vein to a PASIS.

Separately from the perspective of the composition of a CLO portfolio, the results of the EBA Sustainability Framework Consultation highlight that a major impediment to a more developed sustainable securitisation market in the EU is the lack of available sustainable collateral and the absence of a commonly agreed definition of sustainable securitisation. Market participants have differing views on whether the definition should rest on minimum amounts of eligible ESG collateral in the deal portfolio or whether there should be a focus on the use of proceeds more generally.

The work to create a set of guiding principles or rules for a sustainable securitisation framework which is balanced with the need to not unduly (directly or indirectly) restrict the market by inflexibly regulating what can be in the securitisation asset portfolio is on-going. Nonetheless, increased obligor and loan arranger cooperation - whether by way of direct regulation, changes in market practice or indirect pressure from the collateral managers of CLOs which buy the debt - will likely encourage collateral managers to provide their investors with contractual comfort and transparency around sustainability factors in their investment process. This includes the provision of information substantively following the requirements of a PASIS and, potentially, a holistic commitment to a sustainable deployment of the CLO

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proceeds. Increased obligor and loan arranger cooperation will also help collateral managers identify obligors whose businesses are not in line with their own institutional sustainability goals and/or the restrictions they agree to adhere to when issuing a CLO transaction, which is surely a win-win situation for all stakeholders. ■

1 As at 15 September 2021, Creditflux reported a European CLO issuance volume of €23.82bn YTD, versus the total issuance volume in 2020 of €21.62bn, €29.57bn for 2019 and €32.67bn for 2018. S&P Global Market Intelligence also reported that, as of 16 August 2021, European CLO issuance in 2021 stood at €20.99bn, versus €12.67bn in the same period in 2020.

2 Article 6 of Regulation (EU) 2017/2402 relating to a European framework for simple, transparent and standardised securitisation (the EU Securitisation Regulation) and Art 6 of the EU Securitisation Regulation enacted as retained direct EU law in the UK by virtue of the operation of the European Union (Withdrawal) Act 2018, as amended by the Securitisation (Amendment) (EU Exit) Regulations 2019 (SI 2019/660) (the "UK Securitisation Regulation" and when used together with the EU Securitisation Regulation, the "Securitisation Regulations").

3 Article 5 of the Securitisation Regulations.

4 Prior to the effective date of the EU Securitisation Regulation (for securitisations issued on or after 1 January 2019), the prior regime applicable to investment firms laid out in Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CRR) permitted an EU-regulated investment firm with certain regulatory permissions under EU Directive 2004/39/EC (MiFID) to be a valid sponsor retention holder.

5 The definition of an investment firm (which can be a sponsor) is now as follows: "any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis". The definition does not specify the jurisdictional scope, which is at odds with the definition of sponsor as it relates to credit institutions, which states "whether located in the Union or not".

6 Pursuant to Art 3(4)(b) of Commission Delegated Regulation (EU) No 625/2014 (also enacted in respect of the UK Securitisation Regulation).

7 Article 6(1) of the Securitisation Regulations requires that an originator retainer "shall not be considered to be an originator where the entity has been established or operates for the sole purpose of securitising exposures".

8 In July 2018 the EBA published its final report on the risk retention regulatory technical standards related to the EU Securitisation Regulation. On 30 June 2021, the EBA established a new consultation with a further revised draft set of risk retention regulatory technical standards. After consultation with the market, the EBA will submit the recommendations to the European Commission for endorsement.

9 Article 6 (Risk Retention), Art 7 (Transparency Requirements) and Art 9 (Credit-Granting) (the "Direct Obligations").

10 Consisting of the EBA, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.

11 "ESAs' Opinion to the European Commission on the Jurisdictional Scope of Application of the Securitisation Regulation" – 25 March 2021.

12 Paragraph 11 of the ESAs' Opinion.

13 Paragraph 14 of the ESAs' Opinion.

14 Article 5(1) of the EU Securitisation Regulation.

15 "Targeted Consultation on the Functioning of the EU Securitisation Framework" published by the European Commission on 23 July 2021.

16 Article 45a of the EU Securitisation Regulation.

17 A United Nations initiative setting out principles which companies can adhere to in order to commit to certain sustainability principles related to human rights, labour, environment and anti-corruption.

18 For example, North Westerly VI CLO and North Westerly VII CLO.

19 Regulation (EU) 2019/2088 of 27 November 2019 on Sustainability-Related Disclosures in the Financial Services Sector.

20 As defined in Art 2(1) of the SFDR.

21 As defined in Art 2(12) of the SFDR.

22 Article 3(1) of the SFDR.

23 Article 4(1) of the SFDR requires financial market participants at an entity level to publish statements on how they consider the adverse impacts of investment decisions on sustainability factors (or, in certain circumstances, explain why if they do not). At a product level, Art 7 of the SFDR requires (by 30 December 2022) a financial market participant to disclose for each financial product how the product considers adverse impacts on sustainability factors.

24 Whilst the disclosure requirements are currently in force pursuant to the SFDR, the Level 2 technical standards which specify the granular requirements are currently only in draft form and may be amended before they become effective in July 2022.

25 Although notably, a comply or explain approach is available in relation to the disclosure of principal adverse impacts in certain circumstances.

26 Annex A to Commission Decision of 6.7.2021 on the adoption of the answers to be provided to questions submitted by the ESAs under Art 16b(5) of Regulation (EU) No 1093/2010, Regulation (EU) No 1094/2010, Regulation (EU) No 1095/2010 of the European Parliament and of the Council in the period from 1 January 2021 to 30 January 2021.

27 As defined in point (b) of Art 4(1) of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on AIFMs.

Further Reading:

- Brexit and securitisation: the rubber hits the road (2021) 3 JIBFL 198.
- Loan portfolio sales and securitisation (2019) 6 JIBFL 406.
- LexisPSL: Banking & Finance: The rise of green loans and the launch of sustainable CLOs.