KEY POINTS

- In fund financing transactions that are securitisations, the key regulatory requirements that are imposed are risk retention, transparency (and reporting), due diligence and credit granting requirements.
- For risk retention, the relevant master fund typically seeks to be the risk retainer as an originator.
- The analysis of whether the master fund has sufficient substance to act as a risk retainer is more involved where the securitised exposures are debt obligations, as would be the case in NAV or asset-backed facilities of direct lending funds, compared to a capital call facility that constitutes a securitisation.
- In the financing documents, the securitisation regulation requirements will typically be the subject of covenants and representations, breach of which will not benefit from any cure periods – given the regulatory penalties that lenders may face and the additional capital lenders may be required to hold in respect of non-compliant securitisations.
- Despite the extensiveness of the main regulatory requirements, advisers and third-party service providers will typically be able to assist in navigating them and significantly ease the burden.

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Fund finance: the regulatory requirements applicable to securitisations in the EU and UK

In the March 2022 edition of *Butterworths Journal of International Banking and Financial Law* ((2022) 3 JIBFL 198), we briefly explored the analysis undertaken to determine whether a transaction in the European fund finance market constitutes a "securitisation" under the EU[1] and UK[2] regulatory frameworks. If a fund financing does constitute a securitisation, further work is required to establish how the applicable regulatory requirements will be met. In this follow-on article, we survey the application of the key regulatory requirements imposed on participants in securitisations in the EU and UK in the context of fund financing transactions, namely: risk retention, transparency (and reporting), due diligence and credit granting requirements. We also consider the direct applicability of the rules to fund parties and the related provisions participants in these transactions should expect in the financing documents.

RISK RETENTION

The requirement for an originator, original lender or sponsor to retain a 5% material economic interest in securitisation transactions was one of the first regulatory reforms introduced in Europe in the wake of the global financial crisis of 2007/8, and it remains (with some evolution) a core aspect of the regulatory framework applicable to securitisations today. Finding an eligible risk retainer with sufficient substance to satisfy the risk retention requirement in fund financing transactions is often challenging, and the uncertainty the European Banking Authority's (EBA's) June 2021 Consultation Paper introduced to the entity of substance analysis has not helped matters. However, navigating a path through these requirements is often possible, as we describe below.

Meeting the definition of originator

In fund financing transactions that are securitisations, the relevant master fund typically seeks to be the risk retainer as an originator. Pursuant to Art 2(3) of the EU SECR and UK SECR:

> "'originator' means an entity which:
>
> (a) 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 exposures being securitised; or
>
> (b) purchases a third party's exposures on its own account and then securitises them."

How this definition could be satisfied by the relevant master fund will depend on the underlying exposures being securitised, the strategy of the relevant fund and the fund management arrangements that are in place.

If the securitised exposures are the commitments of investors, as would be the case in a capital call facility that constitutes a securitisation, limb (a) of the definition of originator would be satisfied by virtue of the involvement of the master fund in the limited partnership agreement and subscription agreement (or equivalent documents) giving rise to such commitment. It is possible in such circumstances that the master fund may also be an "original lender", if the master fund was not merely involved but concluded such agreements. The advantage of being an original lender is that the sole purpose test would not apply. However, a master fund in a capital

call facility would not always be an original lender if, for example, the investor commitments being securitised include commitments made to feeder funds (entities that aggregate certain investments before feeding them into the master fund) in documents to which the master fund is not a party.

If the securitised exposures are debt obligations, as would be the case in NAV or asset-backed facilities of direct lending funds, there may be more analysis involved. The first question that would typically be asked is whether more than 50% of the debt obligations are originated by the fund (rather than purchased on the secondary market). If this is the case, the master fund would typically aim to fall within limb (a) of the definition of originator, and the next step would be to determine whether the master fund can be properly regarded as acting through the relevant asset holding entity (or entities) in the fund structure. In more straightforward instances, there is only an investment management agreement with the master fund, and the master fund (or the investment manager on its behalf) exerts control over the asset-holding entities through ownership. However, the analysis can be more complex if the relevant asset holding entity (or an intermediate entity) is an alternative investment fund with its own management agreement (often referred to as an underlying AIF). If less than 100% (but more than 50%) of the debt obligations have been directly originated, the master fund must also establish the relevant securitisation.

If less than 50% of the debt obligations are originated by the fund, we may see securitised assets being seasoned (as is common practice in the CLO market) to meet limb (b) of the definition of originator. This would involve the master fund exposing itself in full to the credit risk of the relevant debt obligation for a period of time before the credit risk passes to the securitisation participants. The structure of such seasoning can vary depending on the requirements of lenders and settlement requirements of the relevant fund manager.

The sole purpose test and sole purpose principles

Article 6(2) of the EU SECR and UK SECR provides:

> "For the purposes of this Article, an entity shall not be considered to be an originator where the entity has been established or operates for the sole purpose of securitising exposures."

This is referred to by practitioners as the sole purpose test, and it reflects the concerns of the EBA (expressed in a report published in December 2014) over certain risk retention structures in which the retainer was not an entity of real substance.

While regulatory technical standards (or binding technical standards in the UK) have not been adopted in relation to risk retention, the market has for many years referred to the sole purpose principles laid out in Art 3(6) of the final draft RTS published by the EBA in 2018 (EBA/RTS/2018/01). On 12 April 2022 the EBA published an updated final draft RTS (EBA/RTS/2022/04) that replaces the sole purpose principles at Art 2(7):

> "For the purposes of assessing whether an entity has been established or operates for the sole purpose of securitising exposures as referred to in the first subparagraph of Article 6(1) of Regulation (EU) 2017/2402, the following shall be taken into account:
>
> (a) the entity has a strategy and the capacity to meet payment obligations consistent with a broader business model that involves material support from capital, assets, fees or other sources of income, by virtue of which the entity does not rely on the exposures to be securitised, on any interests retained or proposed to be retained in accordance with this Regulation or on any corresponding income from such exposures and interests as its sole or predominant source of revenue;
>
> (b) the responsible decision makers have the necessary experience to enable the entity to pursue the established business strategy, as well as adequate corporate governance arrangements."

Lenders will typically seek comfort that the proposed risk retainer passes the sole purpose test by reference to the updated sole purpose principle language above, notwithstanding that such language is not yet binding in the EU and has no direct influence in the UK (as it was introduced after the UK's withdrawal from the EU). In particular, for any master fund proposing to act as a risk retainer para (a) of the sole purpose principles will require careful consideration. This analysis often requires significant diligence of the structure, available capital, investments, management and key persons of a fund. Funds should be aware of the necessary analysis, typically undertaken at the early stages of a transaction, to avoid late-stage hiccups in execution.

Direct applicability and finance document restrictions

The risk retention requirements are directly applicable to any originator, original lender or sponsor established in the EU or UK. Even if fund parties are not located in the UK, lenders based in the UK will likely require compliance with both the EU and UK Securitisation Regulation. Since there are significant penalties for breach of these regulations, including fines of up to 10% of annual net turnover on a consolidated basis, fund parties should be as keen as lenders to ensure the analysis is correct.

In the financing documents, the risk retention requirements will typically be the subject of covenants and representations (either in a separate risk retention letter or in the facility agreement itself). These provisions will require the retainer to represent that it is eligible to hold the risk retention (including direct reference to the sole purpose test and the sole purpose principles) and covenant to continue to do so in accordance with EU SECR and UK SECR. In fund structures with multiple

levels between the borrower and the relevant risk retainer, this can result in significant restrictions on changes to the intra-group debt and equity structuring to ensure that the exposure is maintained in the same form as at closing.

In addition, lenders will typically require that breach of any of these covenants or representations are hair-trigger events of default (that is, they will not benefit from any cure periods). This reflects both the regulatory penalties they may face and the additional capital they may be required to hold in respect of non-compliant securitisations.

TRANSPARENCY AND REPORTING

Article 7 of the EU and UK Securitisation Regulations contains significant transparency and reporting requirements to the lenders and competent authority that must be assumed by an originator, sponsor or securitisation special purpose entity (SSPE), including:

- details on the underlying exposures on a quarterly or monthly basis;
- all underlying documentation that is essential for understanding the transaction;
- if a prospectus has not been drawn up, a transaction summary (typically prepared by drafting counsel with relevant excerpts from the facility);
- quarterly or monthly investor reports; and
- *ad hoc* reporting of significant events.

This reporting is significantly more detailed than the normal level of reporting required in fund financing transactions. From our experience, the requirement that has attracted the most difficulty for fund managers not otherwise accustomed to this level of reporting is the requirement in Art 7(1)(a) that necessitates the delivery of information on the underlying exposures (ie each individual debt obligation or investor commitment) on a quarterly basis or, in the case of ABCP (asset-backed commercial paper) reporting, monthly.

The form that this reporting is required to take has been detailed extensively by a regulatory technical standard and implementing technical standard in the EU and a binding technical standard in the UK, both of which provide annexes with the line items that are required to be reported in different types of transactions.

These technical standards also specify requirements regarding the completeness of the information to be reported. The reporting described above only allows information not to be included if it is unavailable to the reporting entity and, even in such circumstances, the usage of these "no data options" is tightly controlled. Information that is available cannot be withheld on the basis that it is confidential. However, this generally does not cause difficulty in fund financing transactions since these will invariably be private securitisations in which the relevant reporting is only delivered to lenders (who are subject to the confidentiality requirements of the facility) and competent authorities (being national regulators) and not to public securitisation repositories.

Whilst the transparency and reporting requirements are relatively cumbersome, our experience is that asset managers have been able to adapt and comply with these requirements. Quite often, this is achieved by delivering raw data to third-party service providers that convert data to the relevant reporting templates and deliver these as required. Often the third-party service provider will already be providing services to the relevant fund and may even be storing the relevant data.

As with risk retention, the transparency and reporting requirements are directly applicable to fund entities, but lenders will seek to include contractual covenants to meet the relevant requirements. Such covenants will typically be given the same status as risk retention covenants, with breach causing events of default without cure periods.

DUE DILIGENCE

Article 5 of the EU SECR and UK SECR sets out two categories of due diligence requirements to be satisfied by institutional investors:

- requirements to be satisfied prior to holding a securitisation position; and
- requirements to be satisfied for as long as they hold such securitisation position.

Article 5(1) outlines upfront requirements to verify that certain listed requirements will be met, including:

- ensuring all the credits giving rise to the underlying exposures are granted on the basis of sound and well-defined criteria and clearly established processes and having effective systems in place to apply those criteria and processes;
- retaining on an ongoing basis a material net economic interest in accordance with applicable risk retention requirements; and
- meeting transparency requirements.

Article 5(3) includes upfront requirements relating to due diligence, which broadly align to the standard credit practices within banks. The assessment should consider the risk characteristics of the individual securitisation position and of the underlying exposures and all the structural features of the securitisation that can materially impact the performance of the securitisation position.

Article 5(4) sets out the ongoing requirements to maintain appropriate written procedures proportionate to the risk profile of the securitisation position, perform stress tests, ensure internal reporting to management bodies and demonstrate an understanding of underlying exposures.

From our experience, the standards imposed by Art 5 are not significantly more stringent than the normal credit processes at banks, so we do not typically expect compliance with the information requests lenders will make to comply with Art 5 to be difficult for fund parties to answer. As with the other matters explored in this article, to ensure that the lender is capable of meeting these requirements, additional information covenants will be included in the relevant facility agreement (or risk retention letter) requiring the master fund to respond to reasonable requests for further information when such information

Feature

Biog box

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is requested to fulfil the lenders' obligations under Art 5.

CREDIT GRANTING REQUIREMENTS

Article 9 of the EU SECR and UK SECR provides certain criteria for credit granting by originators, sponsors and original lenders. In particular, it requires:

> "Originators, sponsors and original lenders shall apply to exposures to be securitised the same sound and well-defined criteria for credit-granting which they apply to non-securitised exposures. To that end, the same clearly established processes for approving and, where relevant, amending, renewing and refinancing credits shall be applied. Originators, sponsors and original lenders shall have effective systems in place to apply those criteria and processes in order to ensure that credit-granting is based on a thorough assessment of the obligor's creditworthiness taking appropriate account of factors relevant to verifying the prospect of the obligor meeting his obligations under the credit agreement."

While this provision is clearly targeted at debt-based exposures (and it should cause little difficulty to lending funds), it is also required to be satisfied in capital call facilities. This requires the relevant master fund to confirm that it has systems in place to ensure the creditworthiness of its LPs prior to accepting commitments from them. Again, in our experience, this causes little difficulty in practice.

We also note Art 6(2) of the EU SECR and UK SECR that provides that the assets in the securitisation shall not be selected with the aim of rendering losses on those assets, measured over the life of the transaction, or a maximum period of four years, that exceed the losses on comparable assets held on the balance sheet of the originator. This is a provision that is clearly targeted at mainstream securitisation transactions and it can make little sense in the context of a fund financing, so many market participants will simply require fund entities to confirm that they have not negatively selected assets to be included in the collateral for the fund financing.

CONCLUSION

Fund parties should be aware of the extensiveness of the main regulatory requirements applicable to fund financings that are securitisations, although advisers and third-party service providers will typically be able to assist in navigating them and significantly ease the burden. Specific fund financings may also encounter nuanced issues not referred to in this article, although they will likely relate to risk retention, transparency or due diligence. Fund parties should also remember that there is value to navigating this complexity: there are typically lower margins on deals structured as securitisations reflecting the potential benefits to lenders of greater liquidity and better regulatory capital treatment. ■

This article is not intended to be relied upon as legal advice.

1 Regulation (EU) 2017/2402 (as amended, the EU Securitisation Regulation, or EU SECR).

2 Regulation (EU) 2017/2402 as retained under the domestic laws of the United Kingdom by operation of the European Union (Withdrawal) Act 2018 (as amended) (the UK Securitisation Regulation, or UK SECR).

Further Reading:

- Fund finance: the securitisation question (2022) 3 JIBFL 198.
- NPE servicers prepare to retain risk under EU Securitisation Regulation (2022) 1 JIBFL 50.
- LexisPSL: Banking & Finance: Articles: Funds finance in the spotlight: emerging developments in due diligence.