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Commentary

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EU Risk Retention Rules and CLOs – the Journey's End?

Although the legislative process is now complete, the process of structuring CLO transactions to comply with the EU risk retention rules has just begun.

The EU's risk retention framework will come into effect next week, marking the end of a long legislative process. The new capital requirements regulation (CRR)[1] of the European Union (EU) and the accompanying directive[2] became effective on 1 January 2014. The related Regulatory Technical Standards (RTS, together with the CRR, the CRR risk retention rules) will come into effect on 3 July 2014.

In this Alert, we consider how the EU risk retention rules might affect collateralized loan obligation (CLO) transaction structures. This Alert does not extend to any tax, other regulatory or other issues relevant when considering CLO transactions. This Alert does not constitute an opinion regarding any particular structure, investor or jurisdiction. The suitability of any structure for any investor in any jurisdiction remains very fact specific.

Executive Summary

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 II[3] and alternative investment funds via AIFMD[4] (together with the affected CRR investors, affected investors).

In short, the EU risk retention rules prohibit affected investors from becoming exposed to the credit risk of a securitization unless any of the sponsor, the originator or the original lender in the transaction discloses that it will retain an interest of not less than five percent of the securitized exposures. Should an affected CRR investor invest in a securitization transaction that does not meet the risk retention, due diligence and disclosure requirements of the EU risk retention rules in any material respect by reason of such investor's negligence or omission, the competent authorities must impose a proportionate additional risk weight against the relevant securitization position equal to no less than 250 percent (capped at 1,250 percent) of the original risk weight of that position. Securitization transactions that do not comply with the EU risk retention rules may be marketed and sold to investors other than affected investors, however the extent of the reduction in liquidity and its effect on pricing for a transaction held only by non-affected investors is unclear.[5]

Under guidance relating to the prior rules, a CLO collateral manager was permitted to hold the required retained interest even if the collateral manager was not an originator, sponsor or original lender. With effect from 1 January 2014, the new rules permit a CLO collateral manager to qualify as the retention holder only if it satisfies the definition of the “sponsor” or the “originator” in the transaction. As discussed below, it is possible to structure a CLO transaction involving the collateral manager as the retention holder under either a “sponsor approach” or an “originator approach”. Also, as discussed below, it should be possible in certain circumstances to structure a CLO transaction involving a third party originator, sponsor or original lender acting as the retention holder.

Workable CLO Structures

Three threshold issues should be evaluated prior to applying the EU risk retention rules. First, the EU risk retention rules only apply to a securitization transactions. A securitization under the CRR, among other conditions, requires tranching. A tranche is “a *contractually* established segment” of credit risk (emphasis added). Market participants have generally treated as securitizations CLO transactions launched by way of the issuance of multiple-tranches of listed notes. However, single-tranche financings (such as senior loans to funds and other vehicles which otherwise raise funds only by issuing shares to investors) may not constitute securitizations. Similarly, it should be possible to structure a CLO warehouse so that it is either not a securitization or is risk retention compliant.

Second, one should consider whether the transaction could be launched as a non-compliant securitization. As mentioned above, a non-compliant transaction may be marketed and sold to investors other than affected investors. The extent of the reduction in liquidity and its effect on pricing for such transactions is unclear.

Finally, we note that an affected CRR investor may invest in a securitization transaction in which no one holds a five percent retained interest provided that that affected CRR investor acts as “sponsor”, “originator” or “original lender” in that transaction. That transaction would be non-compliant for any other affected investor.

A CLO transaction treated as a securitization may become EU risk retention compliant via either a “sponsor” approach or an “originator” approach.

Sponsor Approach

The CRR expands the definition of “sponsor” to include either a “credit institution” or an “investment firm”, compared with only credit institutions in the rules previously in effect (until the end of last year). A credit institution is, essentially, an EU bank, and is not further discussed in this Alert. An investment firm is defined in the CRR by reference to the Markets in Financial Instruments Directive[6] (MiFID) with certain exclusions. The CRR excludes from the definition of investment firm any credit institution, any local firm (defined as firms that are dealing for their own account in derivatives to hedge positions), and any firm not authorized to provide custodial or cash/collateral management services if they provide only certain investment services specified in the CRR and are not allowed to hold client money.

Thus, whether a collateral manager qualifies as a “sponsor” under the CRR will depend upon the MiFID authorizations (or permissions) the collateral manager holds from its EU home country supervisor. A collateral manager which is authorized under AIFMD will not qualify as a manager under MiFID. With the required permissions a collateral manager authorized under MiFID will qualify as a “sponsor” and can be the retention holder in an EU risk retention compliant CLO transaction. Should a manager’s permissions be too narrow, it may be possible for that manager to apply for a variation to its permissions that will qualify it as a sponsor under the CRR.

In addition to having the necessary permissions, a qualifying investment firm must "establish" and "manage" a securitization transaction in order to qualify as a sponsor. Those requirements can presumably be met if a qualifying investment firm acts as the collateral manager in a CLO or is involved in some sub-management or co-management role.

The RTS provides that, where there are multiple sponsors, the retained interest shall either be held in part by each sponsor in proportion to the number of sponsors or in full by the one sponsor whose economic interest is most appropriately aligned with investors (as agreed among the sponsors on the basis of objective criteria such as the fee structures, the involvement in establishing and managing the programme or securitization scheme, and the exposure to credit risk of the securitizations).

Originator Approach

The CRR defines an "originator" as an entity which either originates obligations in the primary markets or acquires obligations in the secondary markets for its own account and securitizes them.

An originator acquiring loans in the secondary market must acquire such loans "for its own account". The originator can meet that condition by entering into purchase contracts directly with the secondary market sellers/brokers.[7] During the warehouse phase, an originator could buy obligations from secondary market sellers and hold the obligations for its own account using the warehouse funding. At closing, for example, the originator would transfer the obligations to the CLO issuer to be securitized. From and after the closing, the originator could, depending upon the structure, continue to acquire and transfer assets for the CLO issuer in satisfaction of the "own account" requirement by acquiring obligations from secondary market sellers and transferring them to the CLO issuer. Whether an entity acquires assets "for its own account" depends upon a number of factors, and the correct method of transfer will avoid characterizing the originator's purchases as agency transactions entered into by the originator on behalf of the CLO issuer.

If a CLO has only one originator, it must transfer all of the assets to the CLO issuer and must thus continue to acquire and transfer all assets to the CLO issuer following the launch of the transaction. Alternatively, the RTS provides that, where the underlying exposures in a CLO transaction are contributed by multiple originators, the retention requirement may be fulfilled in full by a single originator either where that originator has established the CLO and contributes over 50 percent of the total securitized exposures to the transaction or where that originator has established and is managing the CLO without reference to any minimum contribution (other than at least one asset). In these latter cases, the warehouse originator need not acquire and transfer any further assets to the CLO issuer provided that the applicable minimum contribution continues to be met.

An originator may be any "entity" and need not be an EU credit institution or investment firm. Although special purpose entities technically qualify under the rules as originators, CLO investors have, to date, required that originators have some substance. Investor sensitivity is driven by several factors that may change as more transactions are launched, including uncertainty regarding the approach of regulators to different structures. The criteria investors require for having substance vary from transaction to transaction, but originators actually doing business for a variety of clients with their own employees who make independent credit decisions should be acceptable. On that basis, a US business development company might well qualify to act as an originator in a EU risk retention compliant CLO transaction.

Summary and Conclusion

Although the long legislative process for enacting the CRR risk retention rules has finally come to an end, the journey for risk retention is far from over. Market participants are still working to find ways to structure transactions which comply with both the letter and the spirit of the rules. This will continue to be an iterative process, particularly for securitizations which do not fall within the classic originate-to-distribute paradigm, such as CLOs.

When navigating the thicket of the EU risk retention rules, it is important to keep in mind the core objective of the rules – namely to marry decision-making to funds at risk. On that basis, compliant structures should be able to move beyond the more common originator approach of CLO collateral managers acting as qualified sponsors or investing their own funds directly or via affiliated originators.

For example, a sponsor or an originator with substance which makes decisions independently of the CLO collateral manager, even if it invests third party funds, should also be viewed as falling within both the letter and the spirit of the rules. The acceptability of a sponsor or an originator with substance using third party funds appears to be a matter of degree, not principle because several EU risk retention compliant CLO transactions have already been launched involving credit institutions, acting as sponsor or originator, investing their own (third party) funds and not funds of the collateral manager. Just how much substance will be required in order for third party funds to be acceptable will be developed over time.

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Endnotes

[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.

[5] For more detail regarding the CRR risk retention rules, please click here.

[6] Directive 2004/39/EC.

[7] Unlike the language in the CRR permitting primary loan originations to occur through entities related to the originator, secondary market purchases must be made by the originator directly.