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Draft EU Securitisation Regulation – impacts for CLOs

Our July 2015 briefing "CLOs in Europe – a round-up of the pipeline regulatory initiatives" discussed various regulatory workstreams which will impact the future of the securitisation and CLO markets in Europe. At the end of August, a draft proposal from the EU Commission for a new European framework regulation for simple, transparent and standardised (STS) securitisation (the Securitisation Regulation) was leaked to the *Financial Times*. A second version was leaked in mid-September and the official draft of the Securitisation Regulation was published for consultation at the end of September, as part of the Commission's action plan for a Capital Markets Union.

The proposed Securitisation Regulation proposes criteria to define so-called "simple, transparent and standardised securitisations" (STS securitisations), which will be subject to lower regulatory capital requirements than non-STS securitisations. It also aims to be a "one-stop-shop" for all matters relating to EU securitisation, incorporating the current CRA3 transparency provisions and (most significantly for the CLO market) consolidating the EU risk retention and due diligence rules. The Securitisation Regulation will consolidate the current separate sectoral approaches in CRR, AIFMD and Solvency II, into one regulation, with the aim of providing universal rules for all "institutional investors"; i.e. insurance companies and pension schemes, and managers investing on behalf of AIFs and UCITs, as well as banks and investment firms.

Along with the Securitisation Regulation, the EU Commission also proposed a draft amending regulation for the CRR, which deals with implementation of new regulatory capital treatment for securitisation positions in line with the Basel Securitisation Framework, with additional amendments to reduce capital charges for STS securitisations. This was expected and is in line with recommendations made by the EBA Opinion published in July 2015.

This briefing highlights some of the main impacts for CLOs in the proposed Securitisation Regulation.

STS criteria

As anticipated, under the draft Securitisation Regulation, managed CLOs will not be eligible for STS status due to the requirement that there be "*no active portfolio management on a discretionary basis*". Compliance with the risk retention requirements will nevertheless be a component requirement for STS status for eligible types of securitisation.

Risk retention

Indirect and direct retention requirements
The draft Securitisation Regulation retains the due diligence and risk retention obligations imposed on investors under the current regime. In a similar way to the current regime, investors will be required to verify that one of the originator, sponsor or original lender retains five per cent.

However, the draft also introduces a new direct approach to risk retention, under which "*the originator, sponsor or the original lender of a securitisation shall retain on an ongoing basis a material net economic interest in the securitisation of not less than five per cent*". Effectively, in the context of CLOs, this places an obligation on managers to ensure their deals are risk retention compliant.

We expect clarification as to how this new direct obligation will operate for deals with more than one originator(s) and/or sponsor(s). The draft does contemplate a default position that originators shall retain where the relevant parties cannot agree who will retain, but it is hoped that the new technical standards (see below) will be based on the current RTS, which in certain circumstances allow a single originator or sponsor to hold the retention (the manager originator or the majority originator). It should be noted that the approach on this point will need to be modified, as the direct approach places an obligation to retain on *any* originator, sponsor or original lender. In the context of a CLO, there may be dozens of originators but, of course, none may be involved in the transaction. It is hoped that the technical standards will clarify that parties (in particular, loan originators) which are not directly involved in the securitisation transaction will not be required to retain under the new direct approach. Absent such clarification, loan originators would need to diligence that the SPV they are selling to is either not a securitisation or, if it is, that a party has undertaken to retain.

We also expect clarification as to how the new direct obligation will operate jurisdictionally – unlike the "sponsor" definition, "originator" is not defined by reference to any jurisdiction. Thus, a non-EU originator may seemingly be caught by the direct obligation. The explanatory memorandum which accompanies the draft suggests that where the originator, sponsor or original lender is not established in the EU, the indirect approach will continue to apply fully (implying that the direct approach will not) – but such intention is not reflected in the legislation as drafted. This presents an uncertainty that can usefully be clarified.

Originators

There has been significant market and regulatory commentary regarding a possible narrowing of the originator definition. In our July briefing, we quoted the EBA's December 2014 report, which stated that "*the EBA believes that the entity claiming to be the 'originator' should always be of real substance and should always hold some actual economic capital on its assets for a minimum period of time*" (the substance test). In this context, the draft now includes an additional "purpose test" with which originators must comply. The draft documentation states that, for the purposes of the new direct approach, "*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 was changed in the second draft from the initial proposal of "primary purpose".

While this should not affect manager originators established for purposes wider than just securitising assets, it could potentially restrict the use of some third-party originator structures. Rather than an originator only needing to be of sufficient economic *substance*, the new test, as formulated in the draft, requires an additional aspect of *sole purpose*. In this context, "securitising exposures" should be construed to include any activity relating to purchasing or originating loans and then selling such loans to a securitisation SPV. Additional activities will need to be undertaken to enable an entity to qualify as an originator, such as a separate lending business.

This wording has been a primary focus of CLO market participants in the last month, and indeed the scope of the originator definition has been subject to much discussion since the EBA report of December last year. While the new sole purpose limb marks a significant improvement from the initially proposed primary purpose test, careful consideration will need to be given to structures that seek to rely on third-party originator retention holders.

An additional issue that the market will need to consider with respect to originator structures relates to the recast due diligence requirement that institutional investors are required to undertake before investing, under the indirect approach. One of the facts that an investor is required to check is that "*the originator or original lender grants all its credits on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits and has effective systems in place to apply these criteria and processes*". It is unclear how investors will satisfy this requirement in the context of an originator that purchases assets in the secondary market rather than originating assets, on the basis that it will not be granting credits.

Sanctions

Failure to meet indirect obligations

The Securitisation Regulation imposes no sanction on institutional investors for non-compliance under the indirect approach, simply stating that the "competent sectoral authority" (designated by the relevant Member State) shall ensure compliance.

However, with respect to CRR investors (EU banks and investment firms), the amending regulation applies the same additional capital risk weights to positions held by banks and investment firms in a non-compliant securitisation as under the current regime, where the failure has occurred due to the "negligence or omission" of the institution.

Failure to meet direct obligations

Where an originator, sponsor or original lender has failed to meet its risk retention obligations under the direct approach, the Commission proposes that individual Member States impose their own enforcement rules. Notably, this is "*without prejudice to the right for Member States to provide for and impose criminal sanctions*".

There are proposed minimum requirements for such sanctions, which include:

- a public notice of the firm's non-compliance;
- a temporary ban against the management body or other responsible persons from exercising management functions;

- administrative fines of between €5m and ten per cent of total annual group turnover; and
- maximum administrative fines of at least twice the amount of the benefit derived from the infringement.

The draft documents also propose that sanctions for failure under the direct approach be extendable to "members of the management body" of a non-compliant entity, and to other individuals who under national law are responsible for any infringement.

These proposed sanctions are significantly harsher than those applicable to investors under the current and the new regime.

Transparency

The draft regulation also brings in the existing transparency requirements from the current Article 8(b) of Credit Rating Agencies Regulation (CRA3). While this is welcome, as it never made any sense for the transparency requirements to be drafted into a regulation regarding credit rating agencies, there are some concerns. Most notably, the draft purports to apply to all types of securitisations, whereas the existing regime only applies to a narrow list of asset classes, which notably exclude corporate loans (other than SMEs). The new regulation will thus require originators, sponsors, or the issuer to make available on a website for the investor certain information including loan-level data, the prospectus (or, where there is no prospectus, a transaction summary) and the transaction documents. While this is entirely achievable and is for the most part already the practice of CLOs, it is a significant new requirement for any CLO warehouses which fall within the securitisation definition. One suspects that drafting and posting a transaction summary for the benefit of a warehouse lender that itself drafted the transaction documents is not a task that will have much favour with or utility for the market.

Scope and grandfathering

It is proposed that the requirements under the new regulation apply to any securitisations issued on or after its entry into force, being the twentieth day following that of its publication in the Official Journal. It is expected that the final version will be approved by the European Parliament and Council in 2016.

With respect to risk retention, securitisations entered into before the coming into force of the new regime will continue to be subject to the pre-existing rules under Article 405 of the CRR. In effect, this means that transactions issued in compliance with the current retention rules will be grandfathered.

The draft envisages the EBA, in co-operation with ESMA and EIOPA, producing draft regulatory technical standards in respect of risk retention within six months of the entry into force of the Securitisation Regulation. In addition, the draft specifies that the existing RTS will remain in force until the new RTS is adopted. This is helpful, but is similar to the case with the introduction of Article 405 of the CRR and the related RTS in 2014, where the market experienced a period of regulatory uncertainty when the new CRR risk retention rules were in force but the new RTS had not been finalised by the EBA. In the present case, based on the draft regulation, the market will be able to rely on the existing RTS but will be subject to the new rules. As the new rules implement fairly fundamental changes (the direct approach, most notably) which are not contemplated by the current RTS, there will be a period where the market will need to structure transactions based on the primary text alone, without the benefit of a new RTS.

What's next?

The Commission will now send this proposal to the European Parliament and Council for adoption under the "co-decision procedure". Though there is no formal consultation, it is expected that market participants and trade bodies will lobby for some amendments through the usual channels.

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