

CRD IV AND CLOS - REVISED RISK RETENTION REQUIREMENTS: BACK TO THE DRAWING BOARD?

STRUCTURED FINANCE AND DEBT CAPITAL MARKETS

The revival of the European CLO market had appeared to be gaining pace recently with a number of transactions having been brought to market since the start of the year or currently in the pipeline. However, the publication on 22 May 2013 by the European Banking Authority (EBA) of a consultation paper on draft technical standards on the risk retention (or “skin in the game”) and due diligence requirements under the package of measures known as CRD IV, threatens to stop that revival in its tracks and poses significant questions for both future CLO issuances in Europe and the position of existing CLO transactions. We highlight some of the key issues of the EBA paper in relation to CLOs below.

RISK RETENTION – BACKGROUND

Article 122a of the CRD restricts EU-regulated credit institutions from being exposed (e.g. as investor or hedge counterparty) to the credit risk of a securitisation position unless the originator, sponsor or original lender retains a material net economic interest of not less than 5 per cent in respect of that transaction, through one of four specific retention options.

For managed CLOs, the definitions of originator, sponsor and original lender in the CRD are problematic because an entity fulfilling the criteria in those definitions is not commonly involved in a managed CLO transaction. Unlike many other forms of securitisation (including balance sheet CLO transactions), managed CLOs do not have a readily identifiable originator, sponsor or original lender due to the absence of a direct connection between the origination of the syndicated loan (and other) assets underlying the CLO and the creation and subsequent management of the CLO.

On the last day of 2010, CEBS (now the EBA) issued guidance on Article 122a which, together with Q&A issued by the EBA in September 2011, sought to clarify elements of the requirements of Article 122a and, in the case of CLOs, specifically allow for the retention of the economic interest by the “equity investor” in a CLO, provided it has a role in the establishment of, and subsequent changes to, the CLO. It is through the use of this type of structure that a number of the recent European CLO transactions have been issued.

It is currently anticipated that CRD IV and the draft technical standards will apply from 1 January 2014 (replacing the existing regime and guidance). The consultation on the draft technical standards runs until 22 August 2013, with a public hearing at the EBA to be held on 22 July 2013.

CERTAINTY REPLACES FLEXIBILITY

The draft technical standards in the EBA's consultation paper depart from the earlier CEBS guidance and EBA Q&A in a number of areas. From a managed CLO perspective, the most significant departure is the absence of reference to the use of an equity investor to meet the risk retention requirements. The EBA has specifically requested responses as to the extent of reliance on the equity investor route to achieve compliance with the retention requirement and whether it would be possible to meet the retention requirement on the basis of the definitions of securitisation, originator, original lender and the new definition of sponsor under CRD IV.

That definition (of sponsor) has been broadened to include both credit institutions and, now, MiFID regulated investment firms (which would include many, but certainly not all, CLO managers). The EBA's belief appears to be that, by CRD IV's broadening of the definition of sponsor, the market has a clear route to compliance with the retention requirements. Whilst this may be a victory for legal certainty, it comes despite the EBA acknowledging, in a specific reference to managed CLOs, that it might prove difficult for CLO managers to meet the 5 per cent retention requirement, given the capital allocation needed to achieve that requirement. This is the same capital pressure that has, in part, led to the use of the equity investor route to compliance with Article 122a (following the CEBS guidance and EBA Q&A) in recent European CLO issuance. This therefore has the potential to significantly restrict the number of collateral managers able to participate in managed CLO transactions, requiring them to be either a credit institution or investment firm and with balance sheets big enough to meet the retention requirement.

The reference to MiFID-regulated investment firms, in the draft technical standards, is particularly noteworthy for those non-MiFID managers (including those US managers involved in recent managed CLO transactions) structuring transactions to comply with the existing guidance and who will now be looking to comply with the new standards. Managers wishing to create EU-compliant CLO transactions may need to focus as much on the transaction structure as their own regulatory position, including, potentially, the need to obtain MiFID authorisation.

GRANDFATHERING

The consultation paper is silent on the position of existing securitisations (including CLOs) and there is currently no suggestion that those transactions will be grandfathered under the new technical standards. This is of significant concern in a market that has only just started to find its feet both in relation to recently issued deals and those currently being structured, particularly where many had anticipated the re-casting of Article 122a under CRD IV in the same form and with the technical standards following the earlier guidance.

MARKET CLOSURE OR TEMPORARY STOPPAGE?

Whilst it is likely that there will be a period in which the market will need to digest the proposals, it is not clear at this stage whether they will have the same effect on CLOs as the introduction of Article 122a. There will certainly be collateral managers who are able to meet the criteria in the definition of sponsor and will have sufficient capital to satisfy the retention requirement. It will, however, take some time to digest the exact consequences of the draft technical standards both in relation to already issued transactions and those that are being proposed. With that in mind, there are likely to be a large number of responses to the consultation.

In the meantime, we continue to consider with our clients the use of alternative structures to satisfy both the existing regime and the proposed technical standards.

CONTACT DETAILS

If you would like to discuss any of the issues raised in this eBulletin in more detail, please contact:

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