

16 August 2013

To: European Banking Authority
Tower 42 (level 18)
25 Old Broad Street
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United Kingdom

Submitted by email to
EBA-CP-2013-14@eba.europa.eu

Dear Sirs

Consultation Paper on draft Regulatory Technical Standards ("RTSs") on risk retention in securitisation transactions-EBA/CP/2013/14 (the "Consultation Paper")

On behalf of The Loan Market Association (the "**LMA**") working group of CLO investment managers and other CLO market participants (the "**Working Group**"), we would like to thank you for the opportunity to comment on the Consultation Paper and appreciate the continued dialogue on risk retention as it applies to managed CLOs.

INTRODUCTION

The growth of the non-bank institutional lending market has been an important focus of governmental authorities. As CRD IV comes into effect, non-bank institutional lending will be necessary in order to inject much needed credit into the loan markets. The continuing development of the CLO market is, in the view of the LMA and the Working Group, a key component of this initiative.

As the well-publicised €122bn "refinancing wall" approaches, there is a significant risk that many European corporate borrowers will be unable to refinance their existing debt via traditional methods, such as through relationship banks and the syndicated loan market. Further we believe the "refinancing wall" estimates substantially understate the challenge facing the European corporate market, as studies only include widely-syndicated loan facilities - they exclude many loans which have been made available to non-investment grade corporates by relationship banks either on a bilateral or club basis and which are reaching a peak maturity period.

At the same time as there is a peak in refinancing, the European loan market faces reduced lending capacity. Primarily, banks, which provided over 60% of pre-crisis credit, are less able to lend under revised regulatory regimes. In addition, investment capacity for CLOs, which accounted for the vast majority of the remaining credit, is drastically diminishing. The incumbent CLO universe is reaching the end of its permitted reinvestment capability, whilst new CLO issuance has been low due to European-specific regulatory change.

The lower lending capacity will be further impacted by the regulatory capital treatment of European credit institutions following the implementation of CRD IV, which is likely to make lending to the

¹ Moodys - July 2013

sub-investment grade sector less attractive for European credit institutions. Furthermore, it is not feasible for borrowers in Europe to access retail loan funds, which have proven an important source of credit and liquidity in the U.S. (\$110.4 billion supply of loans)² as the current UCITS requirements do not permit a significant portion of loans in a UCITS compliant fund.

Whilst the high yield bond market or the IPO market can fill a portion of this refinancing gap, many borrowers will be unable to access these markets for a number of reasons, such as their enterprise value, size or credit profile. Therefore, as European corporate refinancing requirements substantially increase, there is a concurrent risk of refinancing options and investment capacity substantially diminishing. The U.S. CLO market has experienced a significant revival over the past two years whilst as you are aware the risk retention rules in Europe have created a number of difficulties for the CLO market. The table below sets out the amounts of new CLO issuance over the past two years in the U.S. and Europe. As you can see there has been a stark contrast in issuance levels in the U.S. and Europe. CLOs in the U.S. market account for 50% to 60% of the Institutional Loan market.

	2011	2012	First Half of 2013
U.S. CLO Issuance	€8,885m	€41,572m	€31,948m
European CLO Issuance	€858m	€0	€2,391m

This year, we have started to see a resurgence of new issue CLOs in the Europe. However, this was due in large part to market participants coming to terms with the regulatory framework around risk retention, in particular the flexibility provided in the guidelines published by CEBS in December 2010, (the "**current guidelines**") which allowed a third party equity investor to act as the retention holder. As discussed in more detail below, the changes proposed in the Consultation Paper have created a great deal of uncertainty in the CLO market. The changes are also likely to severely restrict and prejudice the number of CLOs and the type of CLO managers who can issue a new CLO.

The LMA and the Working Group believe that new issue CLOs are a key component to ensuring that there is adequate credit to refinance the existing debt of European corporates. As such it is critical that risk retention regulation strikes the correct balance between addressing the concerns of regulators while taking into account the unique structure of CLOs in order to allow for a robust and functional CLO market.

Before discussing our specific concerns in relation to the treatment of managed CLOs in the draft RTSS, we would like to highlight the recommendations made by the International Organization of Securities Organizations in its report "Global Developments in Securitization Regulation" from November 2012 (the "**IOSCO 2012 Report**")³. Whilst the Consultation paper discusses the recommendations of the IOSCO 2012 report at some length, it fails to consider IOSCO's recommendation 2.3, which clearly contemplates that where risk retention is mandated, jurisdictions will address exemptions from the retention requirement where there are structural impediments to retention, and cites managed CLOs as an example. Whilst we understand that the EBA is bound by the Level One text, we would ask you to consider whether there is room for the RTSS to allow CLO managers some flexibility in interpretation of the Level One text without being in conflict with it. All flexibility which can be afforded to CLO managers in this area is necessary, whilst understanding that risk alignment must be central to the structuring of all securitisation transactions.

² Source: S&P, 12-Aug-13

³ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD394.pdf>

SPECIFIC ISSUES IN RELATION TO CLOs

We have set out below the key concerns that the LMA and the Working Group have with the Consultation Paper. We regard the points below to be critical to ensuring a robust and functional CLO market.

Flexibility in regards to possible retention holders

The Consultation Paper suggests⁴ that as the definition of "sponsor" has been expanded to include investment firms, the technical issues surrounding the definitions of "originator", "sponsor" or "original lender" will no longer exist and CLO managers will be able to meet the definition of a sponsor and thus act as retention holder. This is not the case. The definition of "investment firm" in CRD IV is very narrow and only includes MiFID authorised investment firms who are authorised to do more than just portfolio management (i.e. trading on own account, custody services, holding client money). The majority of European CLO managers do not undertake such additional activities and are thus unable to meet the definition of "sponsor". In addition, non-EU managers and EU managers who will be authorised under the "Alternative Investment Managers Directive" are also unable to fulfil the role of sponsor.

There are a significant number of U.S. CLOs where a non-EU regulated CLO manager has agreed to act as the retention holder in order to ensure the transaction is compliant with the risk retention rules and to enable a U.S. CLO to be marketed and sold to European investors. Under the new regime, many of these transactions will no longer be compliant despite the fact that the retention is being held by the CLO manager. This has created significant uncertainty for investors. European investors in these transactions are likely to suffer limited liquidity and a market value reduction in relation to these investments despite the fact that the CLO manager is holding the retention. The exclusion of recognised third country firms from the definition of "investment firm" creates significant barriers for non-EU regulated CLO managers to comply with the risk retention rules. This may result in a bifurcated market, in particular between the U.S. and Europe. This result runs contrary to statements made in the IOSCO 2012 Report which calls for the standardisation of risk-retention rules across jurisdictions. Moreover, EU institutional and pension fund investors are likely to be excluded from this important U.S. asset class in the future.

In summary, the definition of "investment firms" does not reflect the universe of CLO managers and will restrict the number of CLO managers who are eligible to act as sponsors. This makes it very difficult for CLO managers who fall outside the scope of this definition to act as sponsor. It also appears to run contrary to the policy statement in the Consultation Paper which suggests that CLO managers should act as retention holders. We do recognise that this definition is included in the level 1 text of CRD IV but we kindly request that the EBA take all opportunities for advocacy with the European Commission and other appropriate persons to seek to expand the definition of "sponsor" (for the purposes of risk retention) so that other regulated entities (in the EU and outside the EU) can fulfil the role of sponsor.

Consolidated Affiliates

The current guidance expressly permits the retention to be held by any member of a consolidated accounting group. This guidance was very helpful in the context of CLOs. In particular, CLO managers who may not have the capital to purchase and hold the retention were able to fund the retention through a parent or affiliate. The Consultation Paper is currently unclear as to the holding of the retention on a consolidated basis. Article 14 of the draft RTSs suggests that this is possible but makes reference to (what is now) article 405(2) which suggest that consolidation is only possible where a regulated entity securitises exposures from several other regulatory consolidated subsidiaries. There are a number of instances where CRD IV makes references to "related entities" such as in the definition of "originator". We would ask the EBA to provide clarity on this point by confirming that the retention can be held on an accounting or regulatory

⁴ At page 41 – paragraph 28 of the Cost Benefit Analysis/Impact Assessment.

consolidated basis by any entity within such group regardless of whether such entity is subject to supervision within the EU.

Pre-2011 transactions which substitute exposures.

CLO managers and investors have expressed concerns over the status of CLOs that were issued prior to 1 January 2011. A significant number of these transactions permit some limited asset substitution until their final maturity which will be beyond 31 December 2014. The current framework helpfully clarified that some asset substitution (provided it is "pre-defined in the contractual terms of the transaction")⁵ would not constitute a relevant asset substitution and thus would continue to benefit from the exemption provided to pre-1 January 2011 transactions. The Consultation Paper does not include such guidance and as such many historical CLOs will fall within the scope of risk retention. This creates a number of problems for market participants - many investors in pre-2011 transactions could experience limited liquidity or an adverse capital charge. CLO managers will be faced with navigating the conflicting interests of European investors (who will not wish to see such reinvestment in breach of the requirements) and those of non-European investors who will expect the CLO Managers to comply with their contractual duties of care by exercising their rights to engage in such reinvestment.

Change in sponsor

The Working Group would like further clarification as to circumstances where the CLO manager as sponsor is the retaining party and is subsequently removed. CLO documentation allows a CLO manager to resign or be removed under certain circumstances. In such circumstances, the CLO manager would no longer be a "sponsor" as it is no longer managing the CLO. In addition, requiring the transfer of the retention to the replacement CLO manager may in fact make it difficult for investors to find a replacement CLO manager and any removal of a CLO manager is only effective if a replacement CLO manager is appointed. This is an example of where the rules which are clearly intended to protect the interests of investors may actually serve to prejudice them. We are of the view that in such circumstances the outgoing CLO manager should be permitted to either (i) continue to act as retention holder or (ii) transfer the retention to a replacement CLO manager.

Grandfathering

The Consultation Paper does not specifically address the position of transactions which have sought (in good faith) to comply with the current guidelines. The current guidelines provide some flexibility to allow for certain entities other than originators, sponsors or original lenders to act as a retention holder. In particular the guidelines gave specific examples of other parties who could be considered as appropriate parties to act as retention holder. Given the capital constraints of many CLO managers, participants in the CLO market relied on the specific guidance included in the current guidelines (including the Q&A published by CEBS in September 2011, the "Q&As") and appointed a third party equity investor who was involved in the structuring of the transaction to hold the risk retention. This limited flexibility included in the guidelines has been a key component in the recent revival of the European CLO market. These transactions are unlikely to be able to restructure the retention in order to comply with the requirements in CRD IV. Without grandfathering, investors in these transactions will be negatively impacted despite the fact that the transactions complied with the current guidelines. Even if a capital charge is not imposed, investors will likely suffer reduced liquidity in respect of such investments.

Market participants and investors have relied upon the guidelines in good faith. The lack of any protection for transactions that complied with the guidelines runs contrary to principles of fairness. It also creates market uncertainty as participants will be concerned that other changes may be made to the regulatory framework which will apply retrospectively. Markets need to be able to rely on regulatory guidance provided by regulators at the time it is given. The lack of any grandfathering calls into question the ability of market participants to rely on such guidance. We

⁵ CEBS Q&As, September 2011 Q24.

strongly urge the EBA to discuss this with the European Commission and other relevant EU officials in order to provide clear protections for existing transactions.

Multiple Originators, Sponsors or Original Lenders

The Consultation Paper proposes that where there are multiple originators, sponsors or original lenders, the retention shall be fulfilled by each originator, sponsor or original lender in relation to the proportion of the securitised exposures for which such entities were originator, sponsor or original lender. The current guidance also permitted one originator to retain on behalf of multiple originators (i.e. where such party originated the majority of the securitised exposures).

The LMA and the Working Group are of the view that having the flexibility for the retention to be held by one or more originators in proportion or an originator who has originated the majority of the securitised exposures would provide some flexibility to ensure the proper alignment of interest with investors.

The drafting in the Consultation Paper relating to multiple sponsors is currently unclear. The wording in the Consultation Paper states:

"When the securitised exposures were created or sponsored by multiple originators, sponsors or original lenders, the retention shall be fulfilled...by each sponsor, in relation to the proportion of the total securitised exposures for which it is the sponsor."

A sponsor establishes and manages the securitisation as a whole rather than "sponsoring" particular securitised exposures included in the securitisation. It is unclear how proportionality would be measured in relation to a sponsor given the role of a sponsor. We would view a sponsor who holds the retention as sufficient to satisfy the retention requirements regardless of whether there are multiple parties who meet the definition of sponsor. We would be grateful for any clarification from the EBA in this regard.

RESPONSES TO SPECIFIC QUESTIONS RAISED

Q1. The EBA would like to know to what extent securitisations rely on paragraphs 25-26 of the CEBS Guidelines in order to achieve the retention commitment and would also like to understand if these transactions could also meet the requirements set out in Article 394(1) of the CRR [finalised as article 405(1)] without applying the criteria provided in Paragraphs 25 and 26 of the CEBS Guidelines on Articles 122a of Directive 2006/48/EC taking into account the definition of securitisation according to Article 4(37) of the CRR [finalised as article 4(61)] and the respective definitions of originator, sponsor or original lender.

As discussed above CLOs have had particular difficulties in relation to risk retention. The limited flexibility provided in paragraph 25 and 26 of the guidelines and the further clarification in the Q&As was welcomed by the CLO market. These paragraphs provided some degree of flexibility for other parties to act as retention holder. Without the flexibility provided in paragraphs 25 and 26, and in particular the ability to have a third party equity investor involved in the transaction as a possible retention holder, the universe of CLO managers who will be able to issue a CLO and act as retention provider has been substantially reduced. Only a few CLO managers with a significant balance sheet have the capital to act in such a capacity. This puts smaller CLO managers at a disadvantage as compliance will be very difficult. Investors benefit from a diverse choice of CLO managers with different investment strategies. The current proposals are likely to reduce the universe of CLO managers to managers with large balance sheets. This result is unhelpful to the loan market and detrimental to investors confidence and thus to liquidity. Above all it will hinder corporate financing as Europe seeks to move out of recession. This is seemingly at odds with the goal of greater availability of credit for corporates as banks continue to de-lever.

CLO market participants have already spent considerable time structuring transactions which are compliant with the current guidelines. The removal of this flexibility will create an undue burden on the CLO market as participants try to structure transactions which comply. This is particularly

the case given the very narrow definition of "investment firm" set out in CRD IV. CLO managers who do not fit within the definition of "investment firm" can not meet the definition of "sponsor". Non-EU regulated managers, EU regulated managers who lack certain authorisations, to name a few, do not have a clear path to compliance and as such are forced to consider alternative structures in order to try and fit within the definition of "originator" or "original lender", though in any event balance sheet constraints may well render these alternatives impossible in practice.

Q2: The EBA would also like to understand if, for new securitisations - there are transactions that are likely not to be able to meet the retention requirements following the CRR and associated draft RTS.

As discussed above, we are concerned that the current proposals will result in significant compliance difficulties for CLOs. Also as we discuss in the response to Question 1, the modification of the definition of "sponsor" is unhelpful in a number of instances. Many CLO managers fall outside the scope of the definition as currently drafted. In addition, the removal of the ability to have a third party equity investor involved in the structuring of the transaction and the selection of the portfolio will put smaller CLO managers at a disadvantage and is likely to result in less choice for investors. In addition, European institutional investors may no longer be able to invest in U.S. managed CLOs.

Conclusion

We continue to believe that independently managed CLOs play a vital role in providing credit to European corporates especially at a time when credit is scarce. We do understand and accept the need for investors' interests to be protected, however many of the proposed changes in the Consultation Paper are unhelpful and have already begun to have an adverse effect on a CLO market which has just started to revive. This must be contrary to the best interests of companies seeking credit and to the wider economic prospects within Europe, particularly at a time of bank de-leveraging.

If you would like to discuss these comments further, please do not hesitate to contact Nicholas Voisey of the LMA (nicholas.voisey@LMA.eu.com or + 44 (0) 20 7006 5364), David Quirolo (david.quirolo@ashurst.com or +44 (0) 20 7859 2955) or Anne Tanney (anne.tanney@ashurst.com or +44 (0) 20 7859 2004) of Ashurst LLP.

Yours faithfully



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