New Challenges

The impact of recent regulation affecting international structured debt transactions

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Introduction

The period since the financial crisis has seen a torrent of new regulation and legislation cascading through the financial markets. No corner of the industry remains entirely untouched and securitisation and structured debt is no exception – indeed it is among the most affected. There is a whole raft of regulation and rule-making directed specifically at securitisation, including in Europe risk retention rules, new disclosure and dual rating requirements under CRA3, new data templates required for collateral eligibility by the Bank of England and the European Central Bank and much more besides. In addition, by virtue of its cross-disciplinary nature structured debt frequently gets caught in the crossfire without being a prime target, and industry consequently spends a great deal of time fighting for the exclusion of securitisation from regulation and legislation where it was never really contemplated to be included in the first place. Examples of this include regulation as an alternative investment fund, clearing and margining rules under EMIR and the Volcker Rule in the US (including its extra-territorial effect).

It's not surprising, then, that with the securitisation markets having shrunk dramatically post-crisis– from EUR 454bn in 2007, nearly all of which was placed with investors, to EUR 181 billion in 2013, only EUR 76 billion of which was placed with investors – any rebound is cautious and remains fragile.

On the positive side, there has been a growing realisation among politicians and regulators over the last couple of years that securitisation can be a key component of the overall economic recovery. It is becoming increasingly accepted, for example, that funding of real economy assets like residential mortgages, auto loans, consumer credit, and SME loans is more difficult and less efficient without using securitisation as a funding tool to expand the available range of investors and enable further lending to take place. However, the positive view of certain types of securitisation is not yet reflected in the detail of the regulatory developments. Until those regulatory and political developments are reflected in more proportionate, consistent and targeted regulation, however, the securitisation markets will not expand as they struggle to cope with a regularly shifting landscape that is often tilted away from them.

New Challenges is our latest publication in our New Beginnings series and aims to bring together analysis of some of the most important regulatory developments challenging the recovery of the securitisation and wider structured debt markets and provide some insight as to the direction of travel. We consider everything from the latest Basel Securitisation Framework proposals to the updated risk retention rules, by way of CRA3 and the Volcker Rule. We hope that it will help you not only to identify and define the new challenges that this important area faces, but also to develop solutions to help you meet the letter and spirit of the regulations and remain successful.

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Contents

1. Some AAA ABS Bonds are More Equal than Others: the introduction of high quality/low quality securitisation categories 04

2. Revisions to the Basel Securitisation Framework: protecting the goose that lays the golden eggs? 12

3. Elephant Spotting: risk retention under the CRR 16

4. Sailing in Difficult Waters: CRA3 a year on 22

5. New EU Securitisation Risk Retention Rules: redrawing the roadmap 28

6. Impact of the Volcker Rule on Structured Finance Activities of Non-U.S. Financial Institutions 34

Clifford Chance contacts (London) 45

Clifford Chance contacts (Global) 46

Acknowledgements 47

1. Some AAA ABS Bonds are More Equal than Others: the introduction of high quality/low quality securitisation categories

Five years on from the onset of the credit crisis, it is clear from a quick survey of European regulation relating to securitisation that the product continues to be viewed with suspicion as an instrument which requires heavy regulation. However, following the backlash to the credit crisis, governments and regulators have also come to identify the important role which securitisation can play in helping banks to fund consumer and business lending. A recent joint paper issued by the Bank of England and the European Central Bank on *The Impaired EU Securitisation Market: Causes, Roadblocks and How to Deal with Them* recognises that the European securitisation market continues to be impaired and the market is shrinking. The central banks express concern because as they state "securitisation, if appropriately structured and regulated, can complement other long-term wholesale funding sources for the real economy, including for small and medium-sized enterprises (SMEs)".

This places legislators, regulators and central banks in a quandary; they recognise that whilst regulatory initiatives were designed to address perceived deficiencies highlighted by the financial crisis, the new regimes are not consistent across regulations and/or jurisdictions and that "the proposed changes arguably treat ABS in way that might be perceived as unduly conservative, both relative to their performance in the European context and more particularly relative to other forms of long-term wholesale funding such as covered bonds"[1]. On the other hand, legislators are understandably reluctant to reverse onerous regulatory regimes which were implemented relatively recently to address perceived concerns. How then do they square the circle to resurrect the "good" securitisation which is deemed to be beneficial to the "real economy" and therefore important for the economic recovery in Europe (the political imperative) whilst maintaining that "bad" securitisation contributed to the financial crisis and should not be accommodated? Rather than revising the regulation currently in place so as to treat ABS more proportionately and consistently with other similar asset classes thereby removing the potential for regulatory arbitrage, a consensus seems to be forming around a new bifurcation of ABS focusing on "the promotion of simple structures and well identified and transparent underlying asset pools with predictable performance (so-called "high-quality" securitisation), while still impeding the resurgence of the more complex and opaque structures that contributed to the financial crisis"[2]. In this paper, we will consider the concept of high-quality securitisation, the likely application of the concept, including as proposed for inclusion within Solvency II as well as considering the potential downsides of such an approach including for those structures or asset classes deemed to be "low-quality". In particular, we will argue that whilst the concept of high-quality securitisation which is emerging is well suited to granular pools of consumer assets, it will exclude certain asset classes such as commercial mortgages which justify a different approach to granular assets but should not be treated as an inherently toxic product which is unsuitable for long-term investors such as insurance companies.

Introduction of Type A/Type B securitisation by EIOPA

On 19 December 2013, the European Insurance and Occupational Pensions Authority (EIOPA) published a report titled *"Technical Report on Standard Formula Design and Calibration for Certain Long-Term Investments"* (the "**Report**"), which proposes revised capital charges for securitisations under the standard model (Securitisation Review). Under the latest proposal, EIOPA has introduced two types of risk factor, based on structural, collateral and transparency standards of each investment. Type 1 or Type A securitisation needs to meet tighter criteria compared with Type 2 or Type B securitisation.

[1] Bank of England and the European Central Bank paper on *The Impaired EU Securitisation Market: Causes, Roadblocks and How to Deal with Them.*

[2] Bank of England and the European Central Bank paper on *The Impaired EU Securitisation Market: Causes, Roadblocks and How to Deal with Them.*

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The Solvency II Framework Directive ("**Solvency II**") and the Level 2 Proposals set out the approach to calculating capital requirements on a standardised basis. As the Level 2 measures under Solvency II are still not finalised, some uncertainties remain, though we understand and expect the draft Level 2 measures circulated for discussion in January 2014 and updated in March 2014 (the "**Level 2 Proposals**") to be almost final. Essentially the risks attaching to all of the assets and liabilities of the insurer need to be identified, and the capital required to withstand prescribed stresses calculated, first asset by asset and liability by liability and secondly applying a correlation matrix which takes into account the overall make up of the investment assets and liabilities and allows risk mitigation, diversification benefits and management actions to be factored in. The result of this exercise produces the Solvency Capital Requirement ("**SCR**") which must be supported by own funds, in addition to the technical reserves of the insurer. Insurers are permitted to design their own internal models rather than using the standardised approach subject to approval by the regulator. Such models will however be benchmarked against the standard model.

Under Solvency II, the capital requirement under the Spread Risk Module of the Market Risk element of the standard model SCR calculation, which is applicable to corporate bonds, asset backed securities, infrastructure loans and commercial property linked loans, is somewhat complex and has been the subject of extensive debate. As proposed under QIS5 it was particularly unattractive for lower rated/unrated and longer dated bonds and in particular asset backed securities. Under the March 2014 Level 2 Proposals the position has improved and in particular securitisations have been divided into three categories, "good" and "bad" securitisations and resecuritisations. The capital requirements applicable to high credit rated securitisations backed by certain categories of assets are now more aligned with corporate bonds of similar duration and rating. Securitisations which do not fall within Type 1 will be treated as Type 2 with significantly higher capital requirements or as resecuritisations. It can be noted for example that CDOs and CMBS will be Type 2 as will CLOs unless consisting of loans made up of loans to small or medium size companies. The highest rated Type 1 asset backed security has a stress factor of 2.1% (multiplied by a modified duration factor) whereas a Type 2 similarly rated instrument has a stress factor of 12.5%.

The further criteria applicable for Type 1 or Type A treatment are set out in the Report[3] and are reproduced in the box at the end of this article.

Industry bodies have expressed concern that the capital charges proposed in the Securitisation Review are still too high and will continue to hinder European insurance company investment in securitisation, adversely impacting the ability of securitisations to play a role in financing the real economy, including facilitating the funding of SMEs which was one of the key areas which EIOPA was tasked to consider in the recalibration exercise.

A number of industry commentators have welcomed the concept of high quality securitisation but have expressed concern that the historical period of data used by EIOPA in its exercise to calculate the calibration, namely 2007-2013, is inappropriate and produces damaging results. In particular, there was no recalibration to adjust for the exceptional volatility of the period used in EIOPA's analysis (from 2007-2009), which was caused by historical circumstances that were in large part unconnected with the credit quality of securitisations. One can argue that the volatility was not caused by credit performance of the securitisations but rather the rapid withdrawal of much of the leverage that underpinned much of the securitisation investor base (i.e. wider prudential issues).

Not only does the proposed stress level of 2.1% (multiplied by a modified duration factor) seem unduly high for Type A securitisations, in formulating the Type A/Type B distinction, the stress level for Type B securitisations was increased from 7% to 12.5%. It remains the case that notwithstanding the revision of the capital charges for Type 1 securitisations, the capital charges for the underlying whole loan pools receive capital charges far lower than the senior securitisation exposures backed by those same loans (for both Type 1 and Type 2 securitisations) – even though senior securitisations are inherently less risky from a credit perspective and more liquid than the whole loans. It is unclear why the regulator should encourage a difference between the capital charges for whole loan portfolios versus the senior tranches of securities backed by the same loan portfolios but it is likely to create a strong incentive for insurance companies to make investment decisions based on regulatory treatment of the form of instrument rather than underlying risk. For example,

[3] https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/consultationpapers/EIOPA-13-163/EIOPA_Technical_Report_on_Standard_Formula_Design_and_Calibration_for_certain_Long-Term_Investments__2_.pdf

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commercial real estate debt is an attractive asset class for insurance companies who are incentivised to lend directly rather than invest in the senior classes of CMBS transactions given the categorisation of CMBS as a Type B securitisation.

Why does this matter?

As is clear from the above, the introduction of Type A/Type B securitisation categories for insurance companies may not be sufficient to encourage insurance companies to invest in "high quality securitisation" products given the more attractive capital treatment of other investments with a similar credit risk. Moreover it is likely to make investment in non-granular ABS such as CMBS prohibitive from a capital perspective even though insurers will be incentivised from a capital perspective to make direct loans backed by identical mortgage collateral. Given the importance of insurance companies as a long-term investor base for the economy, this approach is problematic from both a policy and intellectual perspective. In particular, an "asset class" approach to high quality securitisation seems arbitrary and internally inconsistent (for example, it is recognized in the criteria that residential mortgages can be high quality or sub-prime whereas commercial mortgages are excluded irrespective of origination standards or credit quality). This is partly due to the fact that EIOPA has adopted some of the criteria which apply to Prime Collateralised Securities ("**PCS**"); in order to benefit from the PCS Label, a transaction must comply with strict criteria which are asset class specific and are currently largely restricted to consumer assets such as residential mortgages, credit cards, auto loans and consumer loans. Whilst the PCS label is intended to be a "best practice" standard for asset classes eligible for the label, the implementation of similar criteria across regulation may also involve a punitive element which was perhaps not intended or warranted for those asset classes or transaction structures which are not included currently but could be considered in the future.

This is important as it is highly likely that the concept of "high quality securitisation" will become significant outside of the Solvency II context. The European Commission is working on the differentiation of "high" quality securitisation products with a view to ensuring coherence across financial sectors and exploring a possible differential regulatory treatment compatible with prudential principles. The ECB and Bank of England have commended the creation of a "high quality securitsation" concept as a useful measure to restore confidence and issuance levels, and have commended the EIOPA approach:

"For the market to recover in a meaningful way, further measures may be needed. One way of achieving this would be to take into account the simplicity, structural robustness and transparency features of ABS which have meant that low risk and well-structured ABS issued in some markets have displayed strong performance and minimal losses through a period of severe financial stress. In this respect the latest EIOPA proposal for Solvency II as of December 2013 to introduce a distinction between Type A and Type B securitisation as well as the communication on 27th March 2014 from the European Commission to the European Parliament and Council are welcome first steps."[4]

It is encouraging that regulators have started to recognise that regulation should be commensurate with risk and in particular, applied evenly across products with similar risk profiles. It is unfortunate that the criteria adopted by EIOPA in respect of high quality securitisation are generally based on the ECB eligibility criteria, are asset class specific and exclude private transactions which may be perfectly suitable for an insurance company investor. No real rationale has been provided for the increase in capital charges for those transactions which fall outside the criteria; if the intention were to create a super safe sub-category of ABS a simple lowering of the capital charge for structures within the high quality bucket would have made more sense. In our view, it cannot be argued that certain classes of assets are inherently low quality (particularly where regulated institutions can invest in such asset classes directly with vastly different capital treatment) and it would be unfortunate if the concept of high quality securitisation which seems to be gaining traction in regulatory circles was widely adopted in such a narrow construct which will create a cliff effect rather than a graduated approach to risk. Whilst the criteria work fairly well for public transactions in respect of granular asset pools, it is likely that an alternative approach is required for less granular asset classes in respect of which investors can conduct a more detailed credit analysis and it would make sense for such products to have at least an identical if not lower capital charge than the underlying loans.

We anticipate that the debate around the parameters of the concept of "high quality securitisation" will continue but what seems clear is that the concept is here to stay in one form or another. Although there is some way to go, it is encouraging to note the resurrection in

[4] Bank of England and the European Central Bank paper on *The Impaired EU Securitisation Market: Causes, Roadblocks and How to Deal with Them.*

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the eyes of the regulator of certain types of ABS structures and broadly speaking the criteria set out in the Report (and replicated in the box below) work well for the asset classes contemplated. If the regulatory definition of a securitisation remains unchanged, it is to be hoped that sensible parameters will be drawn in future regulatory initiatives around other conservatively leveraged and transparent structures of non-granular assets treated as securitisations which facilitate lending to aspects of the real economy which are not directly linked to consumer debt but enable a wide range of investors to lend to businesses providing student housing, hospitals, hotels, office and retail space. Whilst capital neutrality between underlying loans and a securitisation of the same seems to have a natural logic, it seems that a hefty "complexity" premium will continue to be applied to certain ABS structures for so long as they are deemed to constitute "bad" securitisations. The alternative approach (which in our view, would be the most logically coherent with the risk associated with the actual exposure) would be to re-examine the definition of securitisation to exclude financing of large, non-granular exposures where individual analysis of the relevant exposure is undertaken.

Type A Securitisation Criteria

The following section sets out the proposed criteria Type A securitisations as set out in the Report. It provides legal drafting and explains its purpose, effectiveness and where applicable the available evidence as set out by EIOPA in the Report.

Seniority

Draft legal wording: *After the delivery of an enforcement notice and where applicable an acceleration notice the tranche is not subordinated to other tranches in respect of receiving principal and interest payment.*

Structural features

Legal true sale

Draft legal wording: *The cash flow generating assets backing the securitisation shall be acquired by the securitisation special purpose vehicle in a manner which is enforceable against any third party, and is beyond the reach of the seller and its creditors including in the event of the seller's insolvency.*

Purpose: The legal true sale criterion is important to ensure that the SPV holds the full rights to the underlying assets and is protected from a potential default of the seller.

Effectiveness: The true sale requirement excludes synthetic securitisations.

Evidence: No empirical evidence has been found that synthetic securitisations have generally performed worse than true sales. But synthetic transactions entail additional credit risk as the underlying assets stay on the balance sheet of the originator and credit default swaps are used to transfer their credit risk to the SPV. The investor is therefore exposed to the risk that the bank defaults. As another drawback the definition of a credit event in credit default swap contracts may not be trivial and give thus rise to legal risks.

No severe clawback provisions

Draft legal wording: *There are no severe clawback provisions in the jurisdiction of the seller. This includes but is not limited to rules under which the sale of cash flow generating assets backing the asset-backed securities can be invalidated by the liquidator solely on the basis that it was concluded within a certain period ("suspect period") before the declaration of insolvency of the seller or where the transferee can prevent such invalidation only if it can prove that it was not aware of the insolvency of the seller at the time of sale.*

Purpose: Clawback provisions exist in some jurisdictions. The purpose of this requirement is to ensure that the rights of investors in the SPV to the underlying assets are not impaired by severe clawback provisions.

Servicing continuity

Draft legal wording: *There shall be provisions to ensure that a default by the servicer does not lead to a termination of servicing. In addition, there shall be provisions for the replacement of derivatives counterparties and liquidity providers.*

Purpose: This requirement reduces the risk that a default of the servicer results in an interruption of servicing (i.e. administration, collection and recovery). Such provisions can for instance include triggers for the appointment of a back-up servicer and a high level action plan that outlines the steps to be taken once a back-up servicer is appointed and how the administration of the loans will be transferred. Similar provisions are

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necessary for derivatives counterparties and liquidity providers.

Asset class eligibility and related collateral characteristics

Eligible underlying assets

Draft legal wording: *The cash flow generating assets backing the securitisation shall belong to one of the following asset classes: (i) residential mortgages; (ii) loans to small and medium-sized enterprises (SME); (iii) auto loans; (iv) leasing; (v) consumer finance and (vi) credit card receivables.*

Purpose: The closed list includes only common types of underlying assets. Securitisations of "exotic" underlyings with potentially very heterogeneous risk profiles and limited information available do not qualify. Securitisations of specific underlying assets with unfavourable risk profile are also excluded.

Effectiveness: Collateralised Debt Obligations (CDOs), Whole Business Securitisations (WBS), securitisations of trade receivables and Collateralised Loan Obligations (CLOs) – except for SME CLOs – and Commercial Mortgage Backed Securitisations (CMBS) are excluded from Type A.

Evidence: The underlying of CLOs and CDOs is typically speculative-grade corporate debt. The credit performance of CDOs (excluding CLOs) has been poor. This was not the case for CLOs. But 72.3 % of European leveraged loan CLOs was downgraded between mid-2007 and end 2012 (the only category with a higher percentage were CDOs of ABS).

Homogeneous cash flows

Draft legal wording: *The cash flow generating assets backing the securitisation consist of only one type of assets as set out in the eligible underlying asset criterion.*

Purpose: The homogeneous asset pool reduces complexity. It allows for reporting in a single template and a simpler assessment of the risk drivers. Insurers can easily gain exposure to different types of underlying assets by investing in separate securitisations.

Effectiveness: Securitisations backed by a mixed pool of assets are excluded.

Type of underlying assets

Draft legal wording: *The cash flow generating assets backing the securitisation shall not consist, in whole or in part, actually or potentially, of credit-linked notes, swaps, other derivatives instruments or synthetic securities. This restriction does not include derivatives used strictly for hedging foreign exchange and interest rate risks.*

Purpose: The instruments mentioned above would introduce an additional layer of complexity and risks (including counterparty credit risk). For this reason only derivatives used strictly for hedging foreign exchange and interest rate risk are permitted.

Effectiveness: Securitisations which include structured products or derivatives not used for hedging are excluded.

Rating requirements

Draft legal wording: *The securitisations shall have a credit assessment of at least credit quality step 3 at issuance and at any time subsequently.*

Purpose: A high rating has been no guarantee for low risk but initially low rated issues have performed generally poorly. For this reason Type A securitisations are required to have two ratings of at least triple B minus by a nominated ECAI (Caveat: The mapping between ratings and quality steps has not yet been decided).

No credit impairment

Draft legal wording: *The securitization shall not contain loans that were granted to credit impaired obligors A credit impaired obligor is a borrower (or where there is a guarantor, the guarantor) who*

(i) has declared bankruptcy, agreed with his creditors to a debt dismissal or reschedule or had a court grant his creditors a right of enforcement or material damages as a result of a missed payment within 3 years prior to the date of origination; or

(ii) is on a state register of persons with adverse credit history; or

(iii) has an assessment of creditworthiness by a market accepted credit agency or by the originator indicating a significantly increased risk that contractually agreed payments will not be made compared to the average obligor for the type of loan in the relevant jurisdiction.

Purpose: This criterion excludes loans for which at the time of origination the recent credit history of the borrower or an assessment by the originator or a market accepted credit agency raised doubts that interest and/or principal payments will be made in full.

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Effectiveness: Many US subprime RMBS and UK non-conforming RMBS are excluded (see section 7.9). According to AFME and the German Association of the Automotive Industry (VDA) many auto loan and auto lease securitisations would also be excluded. The concern is that many current borrowers would meet the conditions (i) or (ii). AFME suggested to weaken the requirement by allowing that the borrower might have a negative credit history (i.e. conditions (i) or (ii) are met) if the credit assessment is positive (i.e. (iii) is not met). EIOPA does not support the proposal because the conditions (i) and (ii) have been carefully drafted to ensure that only borrowers with severe credit impairment are excluded. The originator should not be able to "override" the clear evidence for a significantly increased credit risk by referring to a positive external or internal rating.

No non-performing loans

Draft legal wording: *The cash flow generating assets backing a securitisation shall not contain loans which are in default as defined in point 44 of Annex VII to Directive 2006/48/EC at the time of issuance of the securitisation or when incorporated at any time after issuance.*

Purpose: Loans should at least be performing when incorporated in the securitisation at the time of issuance or during the life of the transaction.

Effectiveness: According to AFME securitisations of credit card receivables could be excluded but no evidence has been provided.

At least one payment

Draft legal wording: *The securitisation, except for securitisations backed by credit card receivables, shall be backed by loans for which at least one payment has been made.*

Purpose: The requirement decrease the probability of defaults on loans shortly after incorporation in the securitisation by ruling out that a securitisation consists only of newly originated loans.

Effectiveness: Some US subprime RMBS are excluded (see section 7.9).

Listing and transparency features

Listing requirement

Draft legal wording: *The securitisation shall be admitted to trading on a regulated market in the countries which are members of the EEA or the OECD.*

Purpose: The requirement ensures a minimum level of standardisation and makes sure that sufficient information on the transaction and the underlying asset pool is readily available to existing and potential investors on an on-going basis. The registration for trading does not mean that the securitisation is actually listed.

Effectiveness: The requirement excludes private placements. This affects most of the currently existing US securitisations. They are usually either filed with the Securities and Exchange Commission (SEC) or are subject to legally required standards (US Article 144a Rule). But there is no reason why US securitisations could not get admission for trading on a regulated market.

Transparency, reporting & disclosure requirements

Draft legal wording:

Loan by loan reporting: *Comprehensive loan-level data in compliance with standards generally accepted by market participants is made available to existing and potential investors and regulators at issuance and on a regular basis. Standards issued by central banks shall be considered as generally accepted.*

General reporting: *Relevant information on the transaction in accordance with standards generally accepted by market participants is made available to existing and potential investors and regulators at issuance and on a regular basis.*

Purpose: Readily available and sufficiently detailed information on the underlying pool of loans and the transaction structure is essential for assessing the risks and determining the quality of a securitisation. The availability of sufficiently granular information on the underlying loans is of particular importance. As a result of the loan(level data initiative of the ECB this degree of granularity can be seen as a market standard in the Euro Area. Loan level data is also required by the Bank of England in its refinancing operations. There should be no substantial differences in the informational needs of insurers and banks investing in securitisations. The Basel Committee is currently working on transaction level disclosure requirements. This will hopefully result in generally accepted standards. For this reason it seemed the best approach to simply refer to "generally accepted market practices" instead of producing a detailed list of necessary information.

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Underwriting process

No self-certification

Draft legal wording: *In the case of residential mortgage-backed securitisation, the securitisation shall not contain residential mortgages that were marketed and underwritten on the premise that the loan applicants and, where applicable, their intermediaries were made aware that any information provided might not be verified.*

Purpose: This requirement is essential to exclude mortgage loans where the loan applicant and – where involved – intermediaries might be incentivized to misrepresent essential information (e.g. to overstate income).

Effectiveness: Excludes a large portion of US subprime RMBS as well as a significant part of UK non-conforming RMBS.

Process for assessing creditworthiness

Draft legal wording: *For residential mortgages, the assessment of the creditworthiness shall meet the requirements as set out in [Art. 14 Par. 1 and Par. 2 (a) Mortgage Credit Directive] or equivalent requirements as set out in non-EEA jurisdictions.*

For consumer finance loans, the assessment of the creditworthiness shall meet the requirements as set out in [Art. 8 Par. 1 Consumer Credit Directive] or equivalent requirements as set out in non-EEA jurisdictions.

Purpose: The proposed criteria on the underlying assets would have worked well to exclude poor performing securitisations in the past. But it is impossible to anticipate where risks will arise in the future. Sound underwriting processes are therefore an important safeguard.

This criterion ensures that they meet high quality standards and requires that the lender assesses the borrower's ability to repay the credit in a proper manner, taking into account all relevant information.

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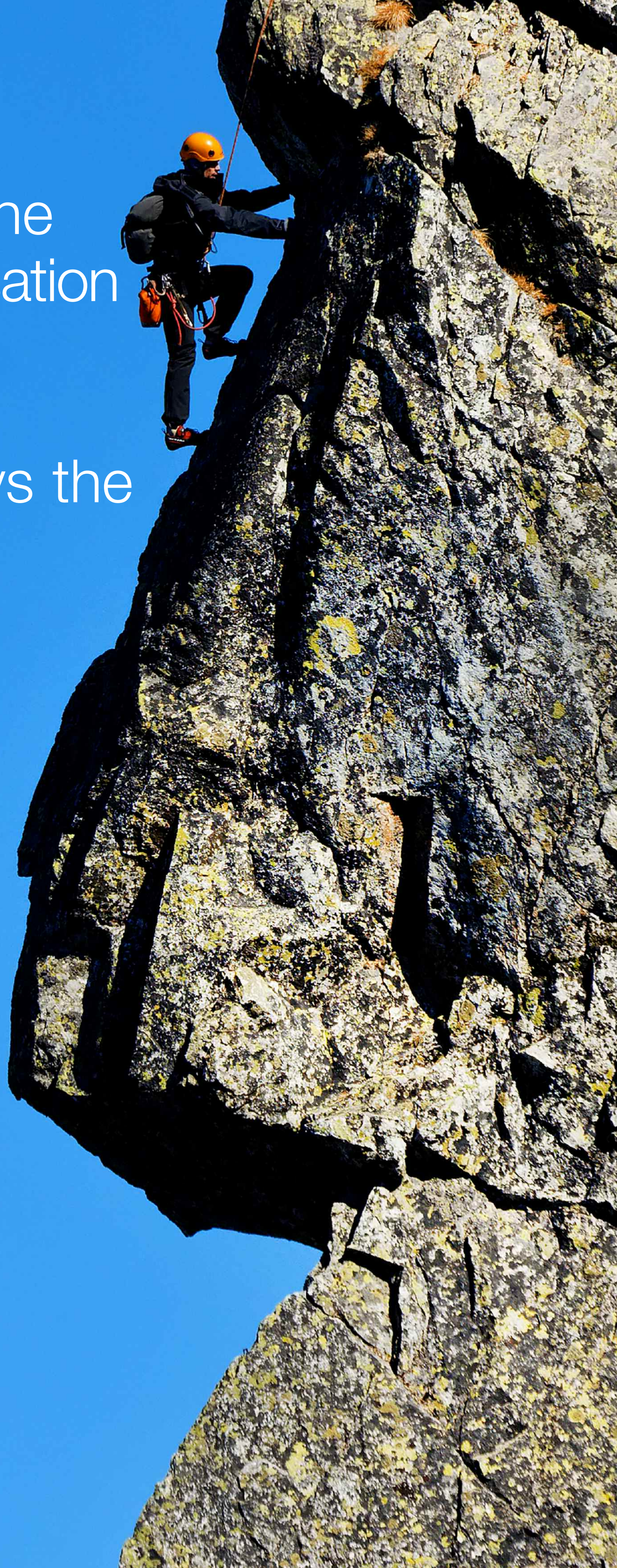
2. Revisions to the Basel Securitisation Framework: protecting the goose that lays the golden eggs?



Background and purpose

The Basel Committee is currently in the process of revising its securitisation framework in order to address the capital standards for securitisation exposures held in the banking book. It has issued two proposals (in December 2012 and December 2013) for a revised securitisation framework thus far.

The aims of the revised framework are to reduce a mechanistic reliance on external ratings, to ensure that risk weights given to securitisation exposures are not too low, to reduce the cliff effects inherent in the current securitisation framework and to increase the risk-sensitivity of the capital charges imposed by the framework. Furthermore it intends to permit the utilisation of the best information available in order to assign capital requirements via its hierarchy of approaches.

Not only market participants but also politicians and regulators are becoming increasingly aware of the importance of a functioning securitisation market to the global economy. It is therefore vital that when imposing regulatory safeguards and checks aimed at protecting the global economy and market participants, that such measures do not strangle the securitisation industry and unfairly make securitisation less attractive than other financing methods, thus resulting in the death of the goose that lays the golden eggs.

Hierarchy of approaches

One of the most notable proposals of the Basel Committee is to introduce a hierarchy of approaches for assigning capital requirements to securitisation exposures. Approaches are organised in order of descending risk sensitivity (and therefore increasingly punitive nature). The idea is that the approach at the top of the hierarchy requires a large amount of information and gives credit to the bank (in the form of a lower capital charge) to the extent possible based on its detailed knowledge of the assets. Conversely, the approach at the bottom of the hierarchy requires very little information in order to assign a risk weight, but punishes the bank (in the form of a higher capital charge) for assuming risks it doesn't understand as well.

Specifically, and wherever possible, banks would apply the Internal Ratings-Based Approach. Where that is not possible, they would apply the External Ratings-Based Approach. Where banks have insufficient information to apply either of those approaches, they would apply the Standardised Approach.

Use of the Internal Ratings-Based Approach would be required where banks that have a suitable IRB model and sufficient information to estimate the IRB capital charge for the underlying pool if it had not been securitised. The use of the IRB method may, however be denied by the national supervisor where they lack confidence that this approach can reflect the risk of the transactions. This may be the case due, for example, to the structural features of the securitisation. The IRB Approach would reduce a mechanistic reliance on ratings and instead depend upon the credit enhancement level, tranche thickness, maturity and the calculation of expected losses. The intention would be for this approach to result in a lower capital requirement than the other approaches further down the hierarchy.

The External Ratings-Based Approach would be applied where the bank could not, for whatever reason, use the IRB Approach, and it is accordingly designed to produce slightly higher capital charges. The ERB Approach would require the bank to know the external or inferred credit rating of the tranche, its seniority in the capital structure, the thickness of non-senior tranches and the maturity of the tranche. Only one rating would be required in order to use this approach as opposed to the two required by the current framework.

The Standardised Approach is intended to produce capital requirements that are slightly higher than under the IRBA but comparable to the ERBA, and is calculated on the basis of the weighted average capital charge for the underlying exposures in the pool with an uplift to reflect any deterioration in the underlying pool.

Where none of the above approaches can be used, a risk weight of 1,250% should be assigned to the exposure.

Unfortunately, the current proposal is calibrated such that it is possible for the IRBA to produce higher risk weights than the other approaches. Ideally, this should be adjusted so that generally it produces lower risk weights. Also, no distinction is made between asset classes when calculating capital requirements. It may be more appropriate to adjust this so that capital requirements are aligned with the historical performance of the particular asset class.

Separately, an Internal Assessment Approach may also be used in the case of unrated exposures to ABCP programmes only. The Basel Committee on Banking Supervision may wish to consider allowing this approach to be applied to unrated securitisation exposures which are not funded through an ABCP conduit.

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Mixed pools

Where a bank is able to calculate IRB parameters for some but not all underlying exposures in a securitisation, the bank may either use the IRBA provided it assigns a 1,250% risk weight to exposures for which IRB inputs cannot be calculated, or alternatively use the other approaches lower in the hierarchy.

Risk weight floor

No matter which approach is used, any securitisation exposure will have a risk weight floor of 15%. The original proposed floor was 20% before the Basel Committee revised this downwards, but it still represents a substantial increase on the 7% risk weight floor in effect under the current framework, and a number of market participants have commented that the the 15% floor may still be too high.

Maturity

Increased risk weights are also applied to exposures with longer maturities. The Committee intends that the tranche maturity input for the IRBA and ERBA approaches should have a five-year cap and a one year floor, and for this purpose has regard to the contractual or legal maturity. A number of market participants have commented that they view the use of legal maturity as too conservative an approach and have asked that a weighted average life be used instead. Otherwise, the current maturity basis could have the effect that a highly rated securitisation exposure which is expected to have a short weighted average life, albeit with a longer final maturity, could have a higher capital requirement than a lower rated unsecured corporate obligation which is expected to have a much longer repayment date.

Maximum capital requirement

The Basel Committee acknowledges in their proposals that the capital charges for a securitisation should be broadly consistent with the capital charges for the underlying pool, in particular senior tranches. However, it needs to be ensured that the framework achieves this in practice. It is currently stated in the proposals that a bank should not have to apply to a senior tranche a higher risk weight than if it held the underlying exposures directly, given the credit enhancement it receives from subordinated tranches, provided that the bank is able to determine risk weights assigned to the underlying credit exposures.

Somewhat helpfully, the proposals also mention that a bank should not be compelled to hold more capital after a securitisation than before, although the Basel Committee are still considering whether this maximum could be applied *pro rata* where only a portion of a tranche is held by the bank. In addition, the initial proposal that originating banks be required to assign a 1,250% risk weight to a below-investment grade securitisation exposure retained by the bank has been deleted.

Early amortisation provisions

An originator or seller of assets into a securitisation which has early amortisation provisions will be unable to apply the securitisation framework to the sold assets where specific operational requirements are not met. This would mean that such assets would be assessed as if they were "on-balance sheet" for regulatory capital purposes.

Resecuritisations

For resecuritisations only the Standardised Approach can be used. An exposure is to be considered a resecuritisation exposure if its cash flows depend on the performance of a pool of assets that contains one or more securitisation exposures. However, this should not include exposures which are retranched and after which they act like a direct tranching of a pool with no securitised assets. Given that that definition is not as clear as it might be, the industry has understandably requested that the language surrounding resecuritisations in the proposal be clarified in the final framework.

Excess spread

The committee has reviewed its attitude to excess spread and now proposes to recognise to a certain extent excess spread in respect of senior tranches.

Derivatives

A bank that enters into an interest rate or currency swap with a securitisation vehicle may assign its swap-related securitisation exposure a risk weight equal to the risk weight assigned to the most senior tranche that is junior to the swap. It may be desirable for the Basel Committee to revise its proposals on this point to also permit the use of the risk weight of any tranches which are *pari passu* to the swap.

Next steps

The deadline to submit responses to the Basel Committee's December 2013 consultative document has now passed. The Committee is in the process of reviewing these responses following which it is expected that it will publish the final standard, implementation arrangements and the timetable therefor. It is worth noting that the Basel Committee have stated that there will be no grandfathering provisions.

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3. Elephant Spotting: risk retention under the CRR

In this article we explore a number of key themes which are becoming apparent around financings of loan portfolio acquisitions and "businesses" generally, in relation to the new EU regulatory capital regime and its recasting of the securitisation risk retention rules. In this context, we also consider the requirement for tranching to determine the distribution of losses "during the ongoing life of the transaction" as a threshold for a transaction being a securitisation and look at Recital 50 of the CRR and the financing of physical assets.

Background

As of 1 January 2014, the Capital Requirements Regulation (CRR) came into force and Articles 404-410 of the CRR replaced Article 122a of the Banking Consolidation Directive and the related Committee of European Banking Supervisors (now the EBA) guidance. The CRR will be complemented by the regulatory technical standards (RTS) adopted by the EU Commission on 6 March 2014 as well as the implementing technical standards (ITS) published by the European Banking Authority (EBA) in December 2013.

Article 4(61) of the CRR defines securitisation as: "a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having both of the following characteristics:

(a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures (*to be known as "**limb (a)**" for the purposes of this article*); and

(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme (*to be known as "**limb (b)**" for the purposes of this article*).

Context is crucial in determining whether or not these tests apply and the mere passing of time could impact on the analysis. In relation to limb (a), if it can be determined that the true credit risk is to an ongoing business rather than the specific assets (exposures) it holds, limb (a) is unlikely to apply on the basis that payments on the debt will be dependent upon the performance of the business, rather than upon an exposure or pool of exposures (although an "exposure" (to the business, including indirectly via a loan exposure) will, of course, still technically exist). In relation to limb (b), it is the structural elements of the transaction which operate prior to enforcement which need to be considered. Allocation of losses post-default will not be relevant for this purpose. We expand on each of these points in our analysis below.

The potential breadth of the definition of "securitisation" means that, although some transactions will clearly fall either within, or without, its scope, the position is less clear for many others. Certain types of portfolio acquisition financings and secured corporate deals are good examples of types of transactions that could fall within the definition and regulators have given very little specific guidance on these types of transaction. While the outcome will turn on the particular facts and must be considered on a case by case basis, key factors can be identified to assist with the analysis. Portfolio acquisition financing and secured corporate deals "bump up against" a consideration of whether they are securitisations from different perspectives: loan portfolio acquisitions are similar to securitisations in that they typically finance financial assets but do not fit within the intended rationale of the regulations; secured corporate deals focus on the ability of a "business" to generate cashflow but employ a number of features traditionally associated with securitisations and so care needs to be taken to ensure that they are not, inadvertently, caught by the regulations. In particular, this article focuses on the acquisition phase of a portfolio financing, which may have features which are distinguishable from any subsequent refinancing of acquisition debt, as the terms of such refinancing and the passing of time could influence the analysis (for example, the refinancing technique used and the ownership of the assets over time may enable a new potential originator to be identified for a securitisation).

Portfolio acquisition financing

An inevitable fall out of the financial crisis has been for banks to delever their balance sheets by selling problem loans and related hedges and crystallising net

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loss positions. In many cases, these sales have been conducted by way of an auction process under which a number of large portfolios (often non-performing, expired or soon to be expired commercial real estate loan portfolios) have been offered for sale. Private equity real estate funds have been large buyers of these assets as they bring with them the servicing expertise to work out and resolve these loans. The purchase of these portfolios is typically financed through a combination of senior bank debt and sponsor equity which typically takes the form of subordinated debt/junior notes.

These transactions involve on their face the transfer of a pool of exposures funded by debt that (given the presence of senior and junior debt) is likely to be tranched. Optically therefore, these transactions can look like a securitisation. If they were to be treated as securitisations for the purposes of the CRR, it could have a detrimental impact on the use of these structures going forward and/or impact on the liquidity of these transactions on syndication or refinancing. A number of arguments can be made, however, to support the view that these transactions should not be treated as securitisations for the purposes of the CRR. We consider each of these arguments below.

What is the true credit risk? Can it be argued that payments under the debt are not "dependent" on the portfolio of assets?

If it can be shown that the true credit risk is something other than the performance of the underlying exposure(s), there is a good argument that limb (a) of the definition of securitisation will not apply. An obvious example is where there is a corporate/fund guarantee of all of the corporate debt but other features may also take a transaction outside the scope of the CRR. This might include, for example, the situation where a substantial sponsor or parent would be obliged or economically incentivised to cure a default by providing additional equity or subordinated debt funding, or a transaction where the receivables generated by the asset are sufficiently dependent upon the management and operation of that asset as part of an ongoing business to be considered corporate credit (see also the arguments below in respect of secured corporate and CMBS transactions).

By definition in the case of non-performing portfolios it is difficult to argue that payments are dependent on the performance of the underlying loans. Rather, the risk underwritten is the achievability of the sponsor's business plan for resolving the underlying loan exposures. This is likely to be apparent from the scope of the loan due diligence exercise which will be tied to ensuring there are no legal impediments to the business plan as well as the key credit terms of the financing, where amortisation, lock-up and sweep requirements and equity release triggers are invariably measured against performance to the business plan. Thus, from an underwriting perspective, repayment of the senior debt is principally dependent on the ability and skill of the sponsor or asset manager to work-out the portfolio. Accordingly in this instance, limb (a) of the definition may well not apply, particularly where the passive retention of the underlying assets alone would not be sufficient to facilitate a timely repayment of the debt.

The degree to which payments on the debt are directly tied to the performance of an exposure or pool of exposures is crucial and it is much easier to distinguish transactions which finance the acquisition of portfolios of defaulted assets in this context, for the reasons set out above. Conversely, there is a degree of likelihood that acquisition financings of performing portfolios could constitute securitisations.

It should not be assumed, however, that it will always be the case that such an acquisition financing would be a securitisation. Regard must be had to the particular facts and the credit analysis of the entity (purchaser or financier) holding the relevant exposures. For example, if a heavy emphasis is placed on the management of the portfolio, or if the purchaser intends to realise its investment in some other way, for example, by selling the portfolio to a third party, or if no losses are to be distributed during the life of the financing, it may be possible to view certain of these transactions as dependent on something other than the performance of the portfolio during the life of the transaction, although this may often prove a difficult standard to meet.

Finally, we note that the identity of an obligor in a transaction may also be relevant, for example, if a long-term tenant is a sovereign entity such that the credit risk is to the relevant sovereign then the regulations applicable to sovereign debt may apply instead.

Is there tranching?

A transaction will only be a securitisation for the purposes of the CRR if there is tranching under limb (b) of the definition, defined as "a contractually established segment of credit risk".

In our view, a transaction funded by a whole loan where the equity interest is provided by way of simple common equity would not constitute tranched debt because the equity is not a contractually established segment of credit risk. However, if the equity interest is held in the form of subordinated debt or profit participating notes, notwithstanding that it may, in economic terms, be a genuine equity interest, the debt like features of these instruments make it very difficult to conclude that they are anything other than "contractually established" segments of credit risk. It is therefore unlikely that limb (b) can be relied on to take the

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majority of portfolio acquisition deals, which are usually funded by genuine equity in the form of an instrument rather than common equity with only a single class of senior debt, outside the scope of the securitisation rules.

We note that liquidity facilities and hedging agreements that are not exposed to credit risk on the securitised exposures (for example, because the notional under the hedge agreement excludes defaulted receivables) are not generally treated as a portion of credit risk for tranching purposes.

Is it intended to be caught by the CRR?

If a transaction falls within the definition of "securitisation" the new EU regulatory regime requires the retention requirement to be satisfied by the "originator", "original lender" or "sponsor" of the transaction. None of the parties involved in an outright acquisition of a portfolio of financial assets would have roles which would typically fall within the target of such definitions, suggesting that these transactions were never intended to be subject to the risk retention provisions of the CRR.

The seller bank could be treated as the "originator" or "original lender" of the exposures. However, the purpose of the transaction is an outright sale of the underlying asset(s) carried out on market terms. As such, the seller is seeking an exit and will not wish to retain an ongoing interest. Indeed, in circumstances where the seller is subject to insolvency proceedings and the sale is being undertaken by an insolvency officer, it is unlikely to be appropriate or even possible for it to do so.

Could the private equity consortium arranging and sponsoring the deal be considered a "sponsor" for the purposes of the CRR? "Sponsor" is defined as a "credit institution or investment firm" which establishes and manages securitisation schemes and, as such, is limited to banks and regulated financial services firms. Moreover, there is typically no issue of securities, a feature usually associated with a securitisation scheme and the definition sits oddly with an outright sale and purchase of a portfolio of assets rather than a funding transaction. Nevertheless, in light of the breadth of the securitisation definition and the potential punitive consequences for non-compliance from a capital perspective, we are aware that some market participants have sought to devise structures which (somewhat artificially) can be shown to fall within the securitisation regime and be compliant from a risk retention perspective notwithstanding that they do not resemble or behave like a securitisation in substance. For example, we are aware of structures that have incorporated the use of an intermediary SPV affiliated with the purchaser to purchase and on-sell the assets and hold the retention as originator. However, this does not change the substance of the transaction, create any better alignment of interests between purchaser and investor or change the economics for the purchaser (being effectively a zero cost option), but it does add complexity.

In conclusion, whilst there is good evidence to suggest that outright disposals of assets are not intended to be caught by the retention requirements of the CRR, this will be subject to uncertainty unless the facts of the particular transaction point to something more concrete, for example, if the true position is an exposure to corporate credit risk or is dependent predominantly upon the ability of an asset manager to work-out the portfolio (rather than the performance of a more static pool of exposures), or unless the transaction is structured without tranching, or conversely if it is designed to be clearly a securitisation in a way which artificially fits it within the definition of securitisation. Market participants, including ourselves, would welcome regulatory guidance on these issues to ensure that portfolio acquisition finance continues to be promoted as a useful tool for deleveraging, particularly deleveraging of the European banking system, and disposals (including out of insolvent entities) whilst supporting a secure regulatory environment.

Secured corporate and single-asset CMBS transactions

Secured corporate transactions involve a number of features traditionally associated with securitisations, for example, the use of a finance vehicle to raise publicly offered notes (and lend the proceeds intra-group to the existing borrower), the use of cash waterfalls to rank the claims of the different classes of creditors in order of seniority and the use of liquidity facilities to meet shortfalls in scheduled debt service.

The arguments as to why these transactions usually fall outside the scope of the CRR are also well established and include:

(i) that the real exposure, upon which the notes are dependent, is to the corporate debt of the borrowing group;

(ii) that the use of the two tier obligor/issuer structure is a financing mechanism for a single overarching transaction, with the issuer-borrower loan acting as a pass-through of the corporate credit risk of the group and not a separate transaction of a stand-alone benefit upon which the notes are dependent. For those transactions that do not rate through insolvency, such as regulated utility transactions, the position is even clearer as investors benefit from a direct guarantee from the operating company;

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(iii) that the transaction cannot in substance be regarded easily as having an "originator", "original lender" or "sponsor" for the purposes contemplated in the CRR (often true of portfolio acquisitions as well); and

(iv) that the borrowing group always retains a substantial equity interest in the assets being secured for the deal, meaning that there is no misalignment of interest and therefore imposing a 5% retention requirement on the obligor group would simply result in 5% of the debt raised taking the form of a new debt instrument (often true of portfolio acquisitions as well).

Consequently, it has generally been accepted for some time now that secured corporate bond transactions involving tranched debt with borrowing group risk are not securitisations and legal analysis is delivered to that effect in connection with these transactions.

Two aspects of secured corporate transactions, however, warrant further analysis: (i) the similarities between some single-asset CMBS transactions and secured corporate deals; (ii) the application of Recital 50 to the financing of physical assets.

Secured corporate or CMBS?

The context in which the definition of securitisation is applied will be crucial. In some circumstances it will be obvious that a transaction constitutes corporate credit, whereas other circumstances will require further analysis. A transaction that involves the financing of a hotel or shopping centre may look like a CMBS transaction on its face, but may actually be dependent on the performance of a business. Although often structured using securitisation expertise, including for tax and ratings purposes, a transaction that finances a hotel or shopping centre will usually be supported by an ongoing business with a genuine equity interest and there may be good legal and/or commercial reasons for that business to finance its real estate assets through a series of single-asset financings as opposed to more traditional corporate finance.

The arguments put forward as to why a secured corporate transaction is not a "securitisation" will often apply to these types of transaction as well, provided the transaction finances a single and not multiple businesses (notwithstanding that it may involve multiple loans to such business or multiple properties). The analysis is more complicated, however, as the underlying exposure is not pure corporate debt but a combination of the underlying portfolio of assets, the corporate element contributed by the active management of the asset as an ongoing business and the economic incentive to continue to support the business should it perform poorly at any time. Whether a transaction falls within, or without, the securitisation regime will often be a matter of degree dependent on whether the corporate aspects of the transaction are sufficient to support the argument that it is really corporate debt. To take the example of a shopping centre, the letting of each retail unit is an evolving asset that requires constant management, and not a static receivable. Moreover, each retail unit is dependent on each other retail unit and the general management of the centre, with income varying depending on the number, range and quality of the other tenants, the ability of the manager to attract tenants and the success of the shopping centre as a whole. In relation to a hotel, the credit would be dependent on the ability of the manager to attract guests, to maintain consistently high levels of occupation and service and to run the hotel efficiently. Factors that may influence the outcome of the analysis might include the size of the obligor interest in the business, the role of the manager or operator and how crucial its role is to ensuring the business generates sufficient income to service the debt, plus whether the manager or operator is part of (or an affiliate of) the borrower group or a third party.

To give an indication of how the analysis can vary depending on the particular circumstances consider, for example, the situation where there is a separate financing of five different hotel assets by way of five separate loans made by the same lender but to separate hotel businesses. It is unlikely that these transactions are securitisations, even if there is subordinated debt, on the basis that the true credit risk of each transaction is to the corporate credit of the particular hotel business. However, if the lender's interest in each of the five loans were sold to an SPV and refinanced by way of a note issuance backed by the interest in each of those five loans, there is a strong argument that the wider transaction is effectively transformed into a securitisation for the purposes of the regulation, unless there is no credit tranching or the lender otherwise retains 100% of the notes for the life of the transaction. This analysis would likely differ again if there were five loans made to the same hotel business, in which case the transaction would continue to look like a corporate exposure even if each of the five loans were transferred to an issuer SPV and refinanced by way of note issuance.

Recital 50

Recital 50 of the CRR states that "an exposure that creates a direct payment obligation for a transaction or scheme used to finance or operate physical assets should not be considered an exposure to a securitisation, even if the

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transaction or scheme has payment obligations of different seniority". This wording replicates the wording previously set out in Article 86 of the Banking Consolidation Directive and as such is not a new provision.

CMBS transactions are one method of financing the operation of real estate assets and some secured corporate transactions will involve the financing of physical assets as well. There has been some consideration given in the market as to whether or not Recital 50 can be relied on to argue that these types of transaction are not securitisations at all for the purposes of the CRR.

In our view, this would be a hasty conclusion to reach for all CMBS transactions in light of the fact that the risk retention requirements of the Banking Consolidation Directive were introduced to address concerns raised primarily around over-heated securitisation markets, which, in this context, notably included the CMBS market which suffered following the crash in commercial property prices. Recital 50 also needs to be considered in light of the wider regulatory regime which requires each exposure to be assigned to one of the classes of exposure set out in Article 147 of the RTS at paragraph 2. Exposures to corporate risk and exposures to securitisations are separate classes and a transaction cannot fall into both. Article 147 goes on to define a separate sub-category of corporate exposure as "specialised lending exposures" created specifically to finance or operate physical assets where the contractual arrangements give the lender a substantial degree of control over the assets and the primary source of repayment is the income generated by the assets (rather than the independent capacity of a broader commercial enterprise). We would note that specialised lending would typically apply, for example, to asset and project finance transactions.

In our view, the better argument is that Recital 50 has been included in the RTS to clarify that "specialised lending exposures" will not constitute "securitisation exposures" notwithstanding that they may well have similar features, rather than a blanket exception for real estate finance not being treated as a securitisation. Finally, we would note that although falling into the specialised lending regime would take a transaction outside the scope of the risk retention rules, treatment as specialised lending would then also need to be applied.

Distribution of losses – ongoing life of the transaction

The final issue to be considered in this article is the requirement of limb (b) that tranches should determine the "distribution of losses during the ongoing life of the transaction".

Where it can be shown that the probability of default across the tranches is the same (for example, where the credit risk for non-payment on each class of debt is the same corporate exposure and that it is only the loss given default that will vary between tranches on enforcement), limb (b) of the definition of securitisation does not apply. Another example of this is where the life of the transaction will terminate as soon as a loss on an underlying exposure occurs and is allocated to a junior tranche which then immediately triggers a default. We would distinguish the above from the situation where a non-payment on a class of notes is deferred until the final maturity date. As there is always the potential for the default to be cured (at least technically), actual loss will not be incurred on the junior debt until the life of the transaction has ended. However, the losses incurred on the underlying assets are likely in our view to be considered to be "distributed" to the junior classes as soon as such losses are sufficient to trigger the deferral of an amount which would otherwise be payable on a junior class. Furthermore, we consider that a notional allocation of losses on a transaction that incorporates a principal deficiency ledger (PDL) feature, even where interest continues to be paid in full by reference to the non-written down balance, would also be caught. We would consider the requirements of limb (b) to be met in both the situations (deferral and PDL) described above.

Conclusion

Detailed analysis will always be required to be carried out for portfolio financing and hybrid CMBS/secured corporate transactions to determine whether or not they fall within the regulatory regime for securitisations contained in the CRR and context is crucial. The analysis above shows that while it will depend on the particular facts, there are often good arguments to support the view that many of these transactions should fall outside the scope of the new regime. This should not be surprising as both their substance and the thrust and intent of the regulations is not consistent with such transactions being treated as securitisations.

Finally, regulatory guidance on these issues would be welcomed by the market to ensure that parties with exposures to these types of transaction can determine whether or not a transaction is a securitisation for the purposes of the CRR on the basis of clear and consistently applied policy.

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4. Sailing in Difficult Waters: CRA3 a year on

Almost a year after their formal coming into force, the latest amendments to the Credit Rating Agencies Regulation (collectively known as "**CRA3**") are still the subject of much discussion. CRA3 expanded the scope and application of disclosure requirements and other ratings related regulation for structured finance instruments – a concept wide enough to include many transactions not traditionally thought of as securitisations. It imposed potentially extensive disclosure requirements and rules requiring at least two ratings. It also promoted the use of smaller credit rating agencies. In this paper, we discuss these three obligations and examine how they are affecting the securitisation markets almost a year after their initial introduction.

General background

As general background, CRA3 focuses (though its effect is not strictly limited to) "structured finance instruments" or "SFIs" and the issuers, originators and sponsors involved in the transactions that create them. The definition of SFI is drafted by reference to the capital requirements regulation ("**CRR**") and as a result is wide enough to include most transactions featuring tranched exposure to a pool of underlying assets where the subordination of tranches determines the distribution of losses during the ongoing life of the transaction. This means that many of the well-known problems of the CRD definition are incorporated and hence some repackagings, certain project and asset finance deals, some real estate finance transactions and potentially certain loans (particularly limited recourse loans) would appear to fall within the ambit of this definition, regardless of whether they would normally be thought of as structured finance.

Although the regulations were originally directed at improving ratings practice and transparency in the securitisation markets, it is these other transactions that have been most concerned that the CRA3 requirements are onerous and problematic to date. By contrast, large, widely distributed securitisations have thus far been much less affected, since it is normal market practice to get at least two ratings and the disclosure obligations have yet to come into force.

Disclosure requirements

The first of the new CRA3 obligations is a broad requirement for the issuer, originator and sponsor of an SFI to jointly publish information regarding the structured finance instrument on a website to be set up by the European Securities Markets Authority ("**ESMA**"). Much remains to be determined – in the regulatory technical standards (the "**RTS**") required to flesh out the disclosure obligations – but the consultation paper and draft RTS published by ESMA on 11 February 2014 give us an indication of the direction of travel as ESMA sees it, which is not encouraging.

The draft RTS

Despite industry having responded carefully and in full to the discussion paper on this topic in the second half of 2013, ESMA has produced a draft RTS that brings an exceptionally wide range of financial products into the scope of its disclosure requirements, excluding only those SFI issued prior to the RTS coming into force. Provided that an SFI (i.e. a financial instrument resulting from a "securitisation" within the meaning of the CRR) is present, the draft RTS would apply disclosure requirements:

- if any of the issuer, originator or sponsor is established (has its statutory seat) in the EU;
- regardless of whether the deal is public – private and bilateral transactions are explicitly in scope, and presumably intragroup transactions would be covered as well;
- regardless of whether the deal has a credit rating – unrated transactions are also explicitly in scope; and
- regardless of whether there is a "security" – money market instruments are expressly included and loans that are part of a securitisation would presumably be included as well.

The data required to be provided under the draft RTS is extensive, highly prescribed and contains a number of categories of data such as default and delinquency rates that are likely to be commercially sensitive for many transactions. A number of the requirements also appear likely to be unworkable in practice (and have been widely criticised as such by industry), including a requirement for loan level data

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to be provided quarterly for every asset class, including highly granular, revolving asset classes with high pool turnover, such as credit card receivables and trade finance receivables.

In addition to loan-by-loan data, the draft RTS also requires transaction documentation (potentially including sensitive documents such as subscription or dealer agreements), a transaction summary, investor reports (to be provided monthly in all cases) and a cash flow model to be disclosed. There is no provision for reduction of commercial terms.

All data provided under the RTS would be published on a website established by ESMA and would be made publicly available with no mention of any restriction on users. No further details of the website are available at this time.

In the event that an SFI is caught, the issuer, originator and sponsor would have to designate one of their number to submit the information required, but would remain jointly responsible for compliance with the disclosure requirements, including the timeliness, accuracy and completeness of the data provided.

The industry response

At the time of publication, the ESMA consultation on the RTS has closed and the market is awaiting ESMA's revised (and almost certainly final) draft RTS which it is required to submit to the Commission on or before 21 June 2014. Given the controversial and problematic nature of the draft RTS, it is not surprising that a large number of market participants responded to the consultation, both in writing and by participating in the ESMA open hearing on the matter. Concerns were numerous and varied, but some of the main points were as follows:

- The securitisation markets are fragile and reduced in size. The proposed RTS do little to increase transparency in the context of existing regulation and transparency initiatives, but they do threaten to increase the regulatory burden and costs associated with securitisation even further, limiting a crucial avenue of funding for the real economy.
- The RTS is unsophisticated and caters only for a classic "true sale" securitisation. It is unclear how it is meant to apply to structures not typically regarded as securitisations or to more complex structures. Crucially, entities with no knowledge or control over the transaction may in some circumstances have obligations imposed on them because they technically fulfil the definition of an "originator".
- Applying the disclosure obligations to unrated, private deals goes well beyond the policy reasons for the CRA Regulation (to reduce mechanisms for reliance on credit ratings), would threaten the private market for structured financing and achieve nothing in terms of investor protection, given the sophisticated nature of the participants in that market and their close involvement in transactions they are funding.
- The approach of requiring loan-level data for all types of transactions is onerous and will not always be justified. For example, in the context of highly granular, quickly revolving assets, it is widely understood that pool-level "aggregate" data is more useful to investors for assessing the credit quality of the portfolio than loan-level data.
- The territorial scope of the disclosure obligations, stated to apply to all three of the issuer, originator and sponsor when any of them is established in the EU, is overbroad, difficult to enforce and will discourage non-EU entities from doing business with EU entities.
- The RTS does not consider other areas of law that may impose competing or conflicting obligations, such as confidentiality, competition law and market abuse law, making it extremely difficult for market participants to know how to comply with all of their obligations under CRA 3 as other applicable areas of law at the same time.
- The draft RTS in many ways exceeds the scope of ESMA's rule-making powers in that it is contrary to the CRA Regulation, the ESMA Regulation and potentially the EU's foundational treaties.

Next steps

It remains to be seen how ESMA will respond to these concerns. However, there was some indication in the consultation paper and at their open hearing that ESMA do not agree with what would appear to be the broad consensus of market opinion. In particular, it appears to be the case that ESMA consider themselves bound to some of these positions by the text of the CRA Regulation itself: a position at odds with many of the arguments presented to them.

Once ESMA publishes its final draft RTS (which it is required do no later than 21 June 2014), the EU Commission will consider that draft and adopt a draft RTS of its own. The EU Parliament and the Council will then have between one and six months to object to the Commission's

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RTS, following which it may be published in the Official Journal and come into force. It is therefore highly unlikely that we will have a final RTS in force before August or September of 2014, and it could plausibly be as late as Q2 2015.

Dual rating requirements

The second requirement is an obligation for rated structured finance instruments to have at least two credit ratings. It remains permitted for structured finance instruments to be unrated – an approach consistent with the EU authorities' stated objective to reduce over-reliance on credit ratings – but where "an issuer or a related third party intends to solicit a credit rating" it is required to appoint at least two credit rating agencies independent of both itself and of each other. Parties to an issuance are further required to consider appointing at least one CRA with no more than 10% of the total market share (**a "smaller CRA"**), an obligation that is not limited to structured finance instruments. If the issuer or related third party then goes on to decide against appointing a smaller CRA, this will need to be documented. This is part of the EU's drive to increase competition in the CRA industry.

For mainstream public "widely distributed" securitisations and other deals seeking to be eligible for BoE or ECB market operations, the appointment of at least two credit rating agencies represents standard practice so has not been regarded as a significant imposition. However, it continues to be more problematic for other "structured finance instruments" where single ratings were more prevalent prior to the introduction of CRA3. This has led, in some cases, to market participants considering transactions with limited nexus to argue, seeking specifically to structure transactions using non-EU entities to avoid the application of the dual rating requirement.

Scope of the obligation

In terms of scope, there were some initial issues around which transactions were caught in the temporal scope of the dual rating requirement and the obligation to consider a smaller CRA. These issues surrounded deals in the pipeline when CRA3 initially came into force because the dual rating obligation applies at the point at which "an issuer or a related third party intends to solicit a credit rating of a structured finance instrument". There were therefore some understandably difficult calls about whether that point had passed before the legislation came into force. Similar considerations applied in respect of the obligation to consider appointing a smaller CRA. Those initial issues have mostly been resolved now and we are not aware of regulators challenging any of the conclusions reached by market participants.

It is also clear that, as with the disclosure requirements discussed above, the dual rating requirement is not limited to structured finance instruments offered to the public or listed on a regulated market. The only exemptions available are for those credit ratings that are completely beyond the scope of the CRA regulation. Such exemptions are very limited, covering matters such as private credit ratings prepared pursuant to a particular order and provided only to the person placing that order.

In terms of territorial application, there remains some uncertainty. The CRA Regulation does not explicitly set out territorial scope. Instead, the market has relied upon twin provisions that impose the obligation to appoint a second rating agency on issuers and "related third parties" (a concept which includes originators, arrangers, sponsors, servicers or any other party that interacts with a CRA on behalf of a rated entity) and that state as a general matter that the regulation creates an obligation on issuers, originators and sponsors "established in the [EU]". Much of the uncertainty arises because the question of how to interpret the concept of being "established" in the EU remains partially unresolved.

Smaller CRAs

One additional area of uncertainty continues to apply to the scope of the obligation to consider appointing a smaller CRA, and specifically whether it applies to all debt or just SFIs. This arises because the obligation itself is expressed in terms that might apply to any issuer or related third party seeking at least two credit ratings, but the general provisions of the regulation suggest that the intention was that it should create obligations for issuers, originators and sponsors established in the EU "regarding structured finance instruments".

In practice, however, compliance has not proved problematic. In our experience issuers of structured finance instruments and issuers of more plain vanilla instruments have largely complied with the obligation to consider a smaller CRA since CRA3 came into force. In cases where a small CRA has not been deemed suitable, a reference in the board minutes of the issuer to the consideration appears to be sufficient to meet the requirement to "document" the decision not to appoint a smaller CRA. In the context of a clear path to straightforward compliance, a conservative approach seems the obvious choice.

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Sanctions

The final area we focus on in this paper is the question of sanctions. Unfortunately, this is yet another area of uncertainty and no particular clarity has been brought to it in the year since CRA3 came into force. No specific sanctions are provided for in the CRA Regulation for the breach of the disclosure or dual rating obligations. The provisions of CRA3 do, however, make explicit that national competent authorities will be responsible for enforcing these provisions. As a result, and despite the fact that no provision is made for Member States to lay down penalties for failures to comply, it seems to us that it will fall to individual Member States of the EU to set out the relevant sanctions. However, it would be for the courts of the individual Member States to decide whether a contravention of the regulation could give rise to civil liability under general principles.

Conclusion

It seems difficult to conclude that the effect of the CRA3 amendments described will be positive for securitisation or, indeed, add much toward any of the broader regulatory goals of increasing transparency of ABS or reducing reliance on ratings. Overall, the approach taken by the European authorities risks muddling the regulation of securitisation by overlaying a number of different legal regimes that are often unnecessarily duplicative and sometimes actually conflict. At the very least, the CRA3 changes will increase the cost of compliance with no material transparency benefits for investors.

Consider the predicament of an issuer as it struggles to fill in one data template for, say, the Bank of England discount window facility and another similar, but non–identical template, to fulfil their CRA3 disclosure obligations – all the while worrying about whether a change in the pool data needs reporting "without delay" as a "significant change or event" under the CRA3 RTS even though they've already determined it's not price-sensitive information that needs reporting under the market abuse directive. To that, add a worry about whether the issuer will be breaching competition law by disclosing commercially sensitive triggers and delinquency rates on their portfolio as they would be required to do under the draft RTS and it would be hard to blame the issuer for throwing up its hands in exasperation.

Industry has emphasised time and again that it supports increased transparency. If the securitisation markets are to thrive, however, regulation must be clear, straightforward, coherent and proportionate. EU authorities should urgently take steps to integrate disclosure requirements under CRA3 with the existing Prospectus Directive, Transparency Directive and Market Abuse Directive regimes as well as thinking carefully and in detail about potential conflicts with confidentiality law and competition law and resolving these. They should also think carefully about the purpose of the disclosure requirements under CRA3 and adjust their scope accordingly.

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5. New EU Securitisation Risk Retention Rules: redrawing the roadmap

The new EU regulatory capital regime came into force on 1 January 2014 and with it a recasting of the securitisation risk retention rules. To accompany these new rules, the European Banking Authority (EBA) published final draft regulatory technical standards (RTS) in December 2013. The RTS and the accompanying implementing technical standards (ITS) were published by the EU Commission on 13 March 2014 and together form an integral part of the new securitisation risk retention rules. The objection period has now ended and the RTS and ITS await publication in the Official Journal of the EU before they can come into force. At the time of writing, we understand that publication in the Official Journal is imminent, possibly by the end of May 2014.

In this briefing we set out the key differences between the final RTS/ITS published by the EU Commission in March 2014 and the initial draft that was the subject of a consultation that closed in August 2013. Next we set out some of the key risk retention issues relevant to CMBS and CLO transactions. We also include our views on some remaining areas of uncertainty relevant to market participants. Finally, we summarise the next phase of the evolving EU securitisation regulatory regime.

Background

The securitisation risk retention provisions of Article 122a of the Banking Consolidation Directive together with the related Committee of European Banking Supervisors (now the EBA) guidance and the Q&A published by the EBA (together, the 122a Guidance) no longer apply as of 1 January 2014. They are replaced by the Capital Requirements Regulation (CRR) which came into force on 1 January 2014 and will be complemented by the RTS/ITS. The RTS and ITS were first released by the EBA in May 2013 as part of an industry consultation process. Set out below are the key differences between the final RTS/ITS and the drafts that were subject of the consultation.

Grandfathering for existing transactions –

The absence of grandfathering provisions in the consultation document was a significant concern that market participants raised during the consultation process. This is because, in the past, market participants relied heavily on the 122a Guidance as the authoritative interpretation of the text of Article 122a. During the consultation process it was therefore argued that investors who acquired securitisation positions relying in good faith on the 122a Guidance should not be penalised if the terms of the new RTS differ from the prevailing regulatory position at the time of initial issuance or acquisition of the investment.

The final ITS indicate partial assistance is available. This assistance, however, will be useful only to current investors in transactions that were structured to comply with the old risk retention rules of Article 122a and the 122a Guidance and then only partially.

The assistance provided comes in the form of the ITS indicating that, when deciding whether to apply a punitive capital penalty to an investor holding an exposure issued between 1 January 2011 and 31 December 2013 that is non-compliant with the new rules, competent authorities may take into account compliance with Article 122a and the 122a Guidance. In that context, it seems unlikely that a punitive capital penalty will be applied to an investor so long as (i) the transaction was issued between 1 January 2011 and 31 December 2013; (ii) the transaction has continuously complied with Article 122a and the 122a Guidance; and (iii) the investor acquired the securitisation exposure prior to 1 January 2014. It seems unlikely to us that this assistance will be extended to investors acquiring those same positions after 1 January 2014.

Even absent a punitive capital penalty for a current investor as at 1 January 2014, however, the possibility of such penalties being imposed on subsequent European investors will severely limit the secondary market liquidity of transactions that are compliant with Article 122a and the 122a Guidelines but not with the rules under the new regime. Consequently, the lack of grandfathering penalises existing investors as well as preventing new ones who are subject to the CRR from investing. If an investor is not subject to the CRR and is able to

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acquire instruments which are not compliant with the CRR, the purchase price they are willing to pay would need to take account of the more illiquid nature of the investment given that many potential investors would be subject to the CRR and unable to invest or, as may often be the case, unwilling to take the risk the instruments are not CRR compliant given the possible punitive capital penalty associated with holding the securitisation position. This is likely to adversely impact both the liquidity and market value of the instrument in the hands of the existing investors.

Fortunately, it appears that the number of transactions that were compliant with Article 122a and the 122a Guidance but not with the new regime is limited. Of those, the greatest concentration will be amongst CLO transactions (which are further discussed below).

Grandfathering for pre-2011 securitisations –

In respect of transactions that were established before 1 January 2011, the risk retention rules will continue to be disapplied indefinitely where the underlying asset pools are left untouched. However, where new underlying exposures are added or substituted after 31 December 2014, that will cause the rules to apply to the transaction (but see below in respect of possible continuing relief under the 122a Guidance). That said, similar to transactions issued between 1 January 2011 and 31 December 2013, the background text and the Q&A section of the final draft RTS/ITS that was published by the EBA in December 2013 states that the 122a Guidance and Article 122a may be used to interpret the rules relating to substitutions of exposures, including product switches, warranty breaches, balance increases and reinvestments.

Unfortunately, reference to the interpretation of substitutions for pre-2011 transactions is not included in the main body of the RTS or ITS. Article 1(7) of the ITS only applies to the risk retention and disclosure rules of Article 405, 406 and 409 of the CRR, and does not apply to Article 404 of the CRR which sets out which transactions are within the scope of the risk retention rules. As the background text and Q&A have now fallen away with the adoption of the RTS/ITS, the final legislation does not provide clarity on how substitutions for such transactions should be interpreted. This may be due to the fact that the mandate of the EBA (pursuant to Article 410(2) of the CRR) did not extend to providing guidance on the application of Article 404 of the CRR and neither the Commission nor the EU Parliament or Council has opted to provide further clarity.

Notwithstanding this, we believe it is helpful that the EBA did initially indicate that for securitisations issued prior to 1 January 2011, the 122a Guidance will be relevant when formulating regulatory views in respect of substitutions of exposures. Under the 122a Guidance, where there is a substitution of exposures for very specific pre-defined contractual reasons pursuant to the original terms of a pre-2011 securitisation, such securitisation will not become subject to the risk retention rules but will remain outside their ambit.

Non-EU trading books –

The consultation document did not provide any flexibility for EU banking groups undertaking market-making activities of securitisation positions through subsidiaries or branches in non-EU jurisdictions. Significant concern was raised during the consultation process that this may operate as a restriction on the ability of EU banking groups to undertake market making activities in non-EU jurisdictions (in particular, the US).

The final RTS goes a long way to clarify this, providing that institutions shall not be deemed to be in breach of the CRR risk retention rules where the securitisation positions are held in the trading book for the purposes of market making activities (among other conditions). Provided these conditions are met, subsidiaries or branches of EU banking groups acting as market makers in non-EU jurisdictions should not be caught by the retention rules.

Multiple originators/original lenders/sponsors –

The RTS also provides some additional clarity in cases where more than one originator/original lender/sponsor is involved in a transaction.

In general, where more than one originator or original lender created the assets being securitised, retention must be satisfied by each on a *pro rata* basis. However, the RTS now also allows for the retention obligation to be fulfilled by a single originator or original lender if (i) the originator or original lender has established and is managing the securitisation or (ii) the originator or original lender has established the securitisation and has contributed over 50% of the total assets.

In the case of sponsors, the retention may be fulfilled either by the sponsor whose economic interest is most appropriately aligned with investors

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(taking into account objective criteria including the fee structures, involvement in the establishment and management of the programme or securitisation scheme and exposure to the credit risk of the securitisations) or by each sponsor proportionately in relation to the number of sponsors.

New vertical slice notes –

To date, there has been a more limited use outside of CLOs and some CMBS of retention option (a), the vertical slice. There are likely to have been a number of reasons for this, including the ease of retaining the first loss tranche (option (d)) and practical worries around retaining pieces of multiple tranches. The RTS introduces guidance confirming that option (a) may be achieved by retaining a vertically tranched note which has a nominal value of no less than 5% of the total nominal value of all issued tranches of notes.

This does not seem to add significant flexibility to what was already contained in the primary text of the CRR. Therefore, it remains to be seen if this option will be economically attractive to retainers and acceptable to investors.

Liquidity facilities –

The consultation document provided that *only* liquidity facilities which fit within certain narrow criteria set out in what is now Article 255(2) of the CRR would be exempt from the risk retention requirements. These criteria include the unconditional ability of the facility provider to cancel the facility, limitations on the purpose for which the facility may be used (including a prohibition on using it to provide credit support in respect of defaulted assets or losses already incurred at the time of the draw) and a requirement that repayment of the facility must rank senior to payments of principal or interest on the notes.

The industry was concerned that many liquidity facilities for existing and new transactions would not fit within this definition and would therefore be subject to the risk retention rules in the same way as it applies to noteholder investors.

The RTS now clarifies that any liquidity facility provider which assumes the credit risk of the securitised exposures or the securitisation positions will be deemed to become exposed to the credit risk of a securitisation, and thereby subject to the CRR risk retention rules. This general test is also applied to derivative and hedge counterparties.

While it will depend on the facts of each particular transaction, to the extent that a liquidity facility provider, or derivative or hedge counterparty, is a senior creditor in the securitisation waterfall and does not become exposed to the credit risk of the assets, it should not be subject to the risk retention rules. In practice this is likely to turn on whether the borrowing base for a liquidity facility (or notional for a derivative) includes defaulted assets.

Retention on a synthetic or contingent basis –

The RTS introduces a new restriction regarding retention on a synthetic or contingent basis. Examples of synthetic or contingent retention may include retention by way of a total return swap on the most subordinated tranche of the securitisation or a letter of credit to the securitisation.

The RTS now provides that where an entity other than a credit institution acts as a retainer on a synthetic or contingent basis, the interest retained must be fully collateralised in cash and held on a segregated basis as client funds. This additional requirement will limit the ability of non-bank entities (including investment firms) to act as the retainer using this method.

Retention on a consolidated basis –

Article 405(2) of the CRR provides a limited ability to retain on a consolidated basis, which has been used in the past as a means of retaining within a group by an entity which may not strictly qualify as an originator, original lender or sponsor. However, this flexibility is heavily restricted as in order to retain on a consolidated basis, there must be an EU parent institution (credit institution, financial holding company or mixed financial holding company), the transaction must securitise assets from several sellers, and such sellers must be included in the same group for regulatory supervision purposes (rather than for accounting purposes).

Unfortunately, the RTS does not provide any further flexibility to permit retention on a consolidated basis. The EBA have expressed a view in public meetings and in the Q&A of the RTS that they are limited by the primary text of the CRR in this regard.

CMBS

Article 405 of the CRR includes a new retention method that was previously not available under Article 122a of the CRD. Article 405(1)(e) now provides that retention may be achieved by the holding of a first loss exposure of not less than 5% of every securitised exposure in the securitisation.

The RTS also includes clarification that this option may be applied so that the credit risk retained is always subordinated to the credit risk securitised. Initial industry

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reaction was that new option (e) could be helpful for CMBS transactions. For some CMBS transactions, this may be the case.

Where a commercial real estate loan is structured as a whole loan it is now possible that the junior part of the loan (the B loan) can be retained as a valid retention under option (e).

However, care must be taken to understand what constitutes the securitised exposure and in this context it may be helpful to distinguish between whole loans which are tranched at the time of the securitisation (or shortly beforehand as part of the contemplated securitisation) and whole loans which are tranched at origination (for instance, to facilitate the earlier syndication of the B loan) but where securitisation of the A loan occurs only at a later date.

In the first case, it is clear that retention of the newly created B loan would satisfy the retention requirement under new option (e). The B loan can be retained by the originator or original lender, and the A loan will be securitised through the issue of various tranches of notes.

While structuring such loans, if the original lender is not proposing to hold the B loan, care will have to be taken to ensure that the lender intending to hold or acquire the B loan has an adequate involvement in the origination process so that it can qualify as an originator under the CRR. For example, it may be a party to the original agreement to provide an undertaking to acquire the B loan at the time of securitisation, and be involved in the loan origination process (including structuring, diligence, documentation and conditions precedent). However, it should be noted that the level of involvement of a B lender required to qualify as an originator (under the CRR) may require the B lender to have regulatory approval in certain jurisdictions (in particular, in jurisdictions which have a banking monopoly). This may be particularly relevant for non-bank B lenders.

Multi-loan CMBS may also be able to implement retention option (e). In such a case, each B lender by holding its respective B loan will retain its *pro rata* share, thereby satisfying the requirements of Article 3(5) of the RTS.

In the case of whole loans that are tranched into A and B pieces but are not immediately securitised, the position remains unclear. There is a concern that the original A/B whole loan could itself constitute a securitisation (with the A loan and B loan both being tranched), meaning that the subsequent tranching of the A loan (into notes) could be considered a re-securitisation. This would attract punitive capital treatment for the noteholders. Industry will likely need to request further guidance on such transactions, perhaps in the form of a question and answer through the Q&A facility on the EBA website. In any case, regulators have not historically been willing to accept a unilateral change in the characterisation and hence capital treatment of a given position over time. It therefore seems unlikely that an institution would be able to tranche a loan into A and B pieces and treat them as non-securitisation exposures but then subsequently tranche the A loan into notes (and hold the B loan as the retention piece) while simultaneously arguing that the A/B loan should now be treated as a securitisation.

It should also be noted that option (e) will be of limited use with respect to structurally subordinated B or mezzanine loans (usually structured as a debt at the holdco level). Loans that are structurally subordinated are not part of the exposure that is being securitised (i.e., it is not a whole loan). Hence, it would not qualify as a securitised exposure for the purposes of option (e).

CLOs

When the initial draft of the RTS was published in May 2013 there was consternation in the CLO industry due to the fact that it did not countenance the retention piece being held by an independent third party investor whose interests were most aligned with those of other investors in the transaction as contemplated in the 122a Guidance. Unsurprisingly the final RTS/ITS has not reintroduced this flexibility. However, certain clarifications relevant to managed CLOs have been included in the final draft RTS/ITS (in some cases, the following restates more specifically points made generically elsewhere in this briefing):

(i) where there are multiple originators of the exposures (as would typically be the case in a managed CLO transaction where assets are acquired in the market both during the warehouse and ramp-up phases as opposed to from the balance sheet of one particular seller), an entity may act as retention holder if it either (a) created or sold some of the assets into the CLO (there is no minimum percentage requirement) and has established and is managing the CLO, or (b) created or sold over 50% of the assets into the CLO and established the CLO but without needing to have any ongoing management role. The RTS does not confirm whether a first loss warehouse provider can act as retention holder but a question has been submitted in relation to this on the EBA website which is currently awaiting answer;

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(ii) if a CLO which issued prior to 1 January 2011 permits asset substitutions after 2014, for example because its reinvestment period is still continuing after this point in time, or otherwise because limited substitutions are permitted post-reinvestment period, the EBA have indicated that such transactions will be subject to the 122a Guidance when it is determined if they are subject to the CRR risk retention rules. This should mean that if asset substitutions are only permitted post-2014 for very specific pre-defined contractual reasons pursuant to the original terms of the CLO, that such CLO should fall outside the ambit of the risk retention rules;

(iii) for CLOs which issued in the period from 1 January 2011 – 31 December 2013 and which were structured so that the retention holder was an independent third party equity investor, regulators may take into account the 122a Guidance when determining if investors failed to comply with the CRR in entering into any such investments. This implies that regulators will show some leniency to investors in such CLOs who acquired their position in good faith on the basis of the then current 122a Guidance and therefore not be subject to a punitive risk weighting on their investment. However, such investors are still likely to suffer a loss of liquidity and possibly market value on such investment;

(iv) unfortunately no provision has been made for the retention piece to be held on a consolidated accounting basis and the restrictive and difficult drafting of the CRR must be complied with in respect of any consolidated holding; and

(v) no accommodation has been made for an entity to act as retention holder which does not fit within the technical definition of sponsor, for example due to it not having certain specified MiFID permissions.

Next steps

The final RTS and ITS are, at the time of writing, expected to come into force imminently. As the CRR rules replaced Article 122a from 1 January 2014 and the 122a Guidance no longer applies there has been a level of uncertainty surrounding aspects of the risk retention rules in securitisations that do not squarely fit within the provisions of the CRR. Industry still needs to spend time assimilating the new rules and submitting questions to the EBA to take advantage of the Q&A facility on the EBA website. As a result of this uncertainty, new securitisations in the first part of 2014 have concentrated around more straightforward transactions that are clearly within the provisions of the CRR itself. It may be that some securitisations with more complex or unusual retention structures are held back until later in 2014 when hopefully further assistance is given by the EBA through specific Q&A.

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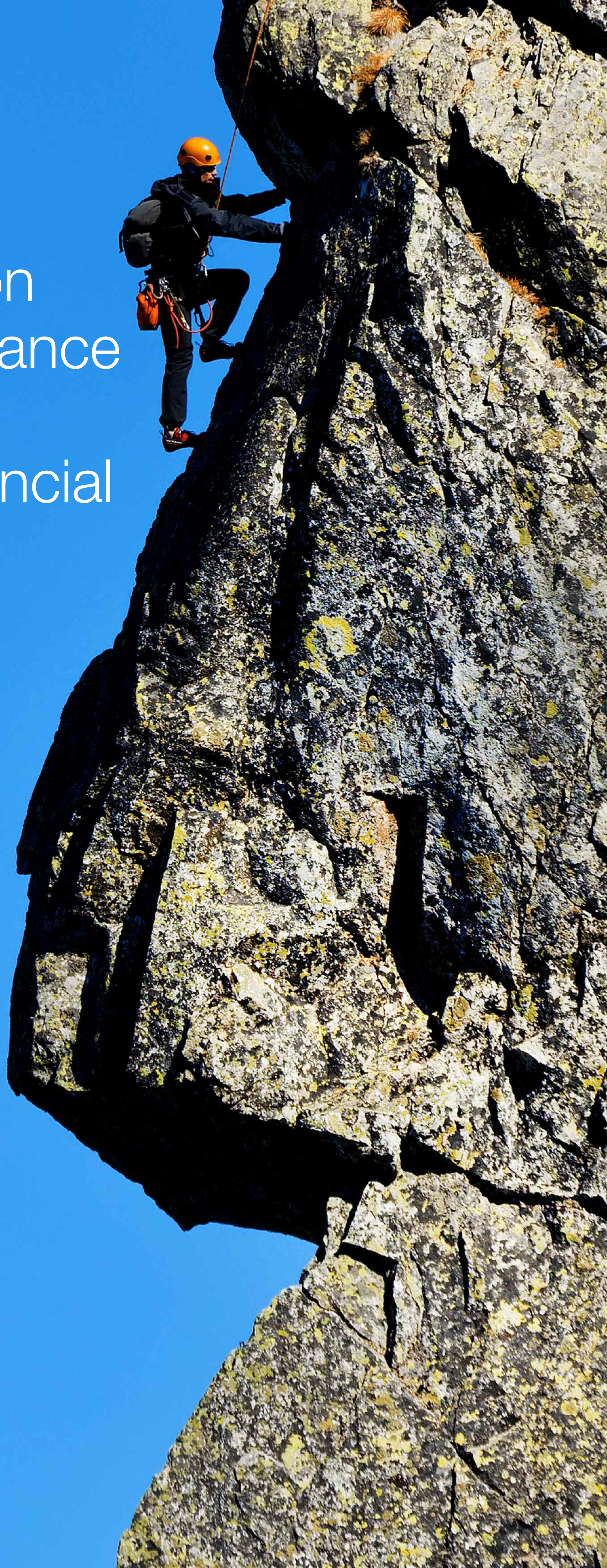
6. Impact of the Volcker Rule on Structured Finance Activities of Non-U.S. Financial Institutions



The cornerstone of the reform efforts to ensure the future stability of the U.S. financial system following the 2008 financial crisis was the passage by Congress of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Among other things, the Dodd-Frank Act amended the U.S. Bank Holding Company Act (the "BHCA") to include provisions that are commonly referred to as the "Volcker Rule."[1] These provisions generally prohibit a "banking entity" from engaging in short-term proprietary trading, with several key exceptions.[2] The Volcker Rule also includes prohibitions related to "covered funds" that restrict banking entities from owning, sponsoring, or having certain interests in, or transactions with, entities designated as covered funds, subject to several important carve-outs. These fund-related prohibitions are intended to prevent banking entities from having exposure to the risks of proprietary trading activities of other entities, such as hedge funds and private equity funds. Although the Dodd-Frank Act was adopted in 2010, it required the drafting and implementation of complex regulations to become effective. These regulations became effective 1 April 2014, but banking entities generally have until 21 July 2015 to comply in full.

In December 2013, a group of U.S. regulators specified by Congress (the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission, collectively, the "Agencies") jointly adopted final regulations to implement the Volcker Rule (the "Implementing Regulations").[3] As a result of the broad manner in which the terms "banking entity" and "covered fund" are defined in the Implementing Regulations, the Volcker Rule has the potential to affect a wide range of structured finance activities, including those of non-U.S. financial institutions that have operations in the United States through branches or subsidiaries.

We identify and discuss some of the key Volcker Rule issues facing non-U.S. financial institutions engaged in structured finance activities below.[4]

Basics of the Volcker Rule's covered fund prohibitions

The Volcker Rule, as implemented, generally prohibits a banking entity, when it is acting as principal, from acquiring or retaining (directly or indirectly) any equity, partnership or other similar ownership interest in, or acting as sponsor to, a "covered fund" – subject to several exceptions. As discussed in more detail below, the term "banking entity" generally includes any non-U.S. bank that maintains a U.S. presence through a branch, agency or subsidiary as well as any parent company, affiliate or subsidiary of that non-U.S. bank.

"Covered fund" is a defined term that generally is intended to apply to private investment funds (such as hedge funds and private equity funds) by referencing two provisions of the U.S. Investment Company Act of 1940, as amended (the

[1] Section 619 of the Dodd-Frank Act added a new Section 13 to the BHCA (codified at 12 U.S. Code §1851, available here: http://www.gpo.gov/fdsys/pkg/USCODE-2010-title12/pdf/USCODE-2010-title12-chap17-sec1851.pdf), which became effective in July 2012.

[2] This piece does not focus on the portion of the Implementing Rules related to proprietary trading, which include several important exclusions from the definition of "proprietary trading" as well as conditions for a number of permitted proprietary trading activities. For a discussion of this topic, see our December 2013 client briefing, available here: http://www.cliffordchance.com/briefings/2013/12/u_s_regulators_finallyimplementthevolckerrule1.html

[3] As six different agencies are charged with administering these regulations, it is generally expected that it will be extremely difficult to obtain any further regulatory guidance or exemptive relief related to the Volcker Rule.

[4] This piece does not seek to address issues related to investments in private funds. For an overview of key considerations for non-U.S. banks and their private funds teams, see the April 2014 paper which we prepared jointly with Campbell Lutyens, available here: http://www.cliffordchance.com/briefings/2014/04/the_volcker_rulekeyconsiderationsfornon-us.html

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"Investment Company Act") that are typically relied upon by these funds to achieve exemption from the various regulatory requirements of that act: Sections 3(c)(1) and 3(c)(7). Section 3(c)(1) provides an exclusion for any issuer whose outstanding securities are beneficially owned by 100 or fewer holders and is not making, and does not presently propose to make, a public offering.[5] Section 3(c)(7) provides an exclusion for funds whose outstanding securities are owned exclusively by "qualified purchasers" at the time of acquisition and is not making, and does not presently propose to make, a public offering. Due to the very broad definition of "covered fund", the Implementing Regulations explicitly exclude more than a dozen types of entities that would otherwise technically be considered covered funds from the definition of covered fund because they were not intended by Congress to be subject to the restrictions of the Volcker Rule. Entities that fall within the definition of "covered fund" but are unable to qualify for one of these broad *exclusions* may, nevertheless, qualify for more limited *exemptive* relief.

Any equity or partnership interest or any of the following types of "similar" interests in a covered fund would constitute a prohibited "ownership interest" for purposes of the Volcker Rule, unless an exception applies:

- the right to participate in the selection or removal of the covered fund's general partner, managing member, director, trustee, investment manager, investment adviser, or commodity trading advisor (excluding the right to exercise creditors' remedies upon the occurrence of an event of default or an acceleration event);
- the right to receive a share of the income, gains or profits of the covered fund;
- the right to receive the covered fund's remaining assets after all other interests have been redeemed and/or paid in full (excluding the right to exercise creditors' remedies upon the occurrence of an event of default or an acceleration event);
- the right to receive all or a portion of any excess spread (equal to the aggregate interest payments received in respect of the covered fund's underlying assets *less* the aggregate interest payments made in respect of the covered fund's other outstanding interests);
- the interest is subject to provisions that permit the amounts payable by the covered fund in respect of the interest to be reduced based on losses arising from the covered fund's underlying assets, by allocating losses, write-downs or charge-offs to the outstanding principal balance of, or by reducing the amount of interest due and payable on, the interest;
- the right to receive income on a pass-through basis from the covered fund, or to returns at a rate determined by reference to the performance of the covered fund's underlying assets; or
- any synthetic right to have, receive, or be allocated any of the foregoing.

With respect to any entity that is considered a "covered fund", any of the following activities would constitute "sponsoring" a covered fund for purposes of the Volcker Rule, unless an exception applies:

- serving as a general partner, managing member, or trustee of the covered fund, or serving as its commodity pool operator, in the case of a covered fund that is also a commodity pool;
- selecting or controlling (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of the covered fund; or
- sharing with the covered fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name.

These criteria for sponsorship under the Volcker Rule are markedly different from those included in other regulations relevant to asset backed securities. Accordingly, a banking entity may be considered a "sponsor" of a covered fund for purposes of the Volcker Rule even if it is not a sponsor for purposes of these other regulations.

The Volcker Rule's covered fund prohibitions also generally restrict banking entities from exposing themselves to the credit risk of covered funds that they advise or own (these additional restrictions are known as the "Super 23A" restrictions). The "Super 23A" restrictions of the Volcker Rule prohibit any banking entity:

- that serves as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund; or
- that, in accordance with an available exemption, organises a covered fund, offers or continues to holds any ownership interests in a covered fund,

from entering into any "covered transaction" with that covered fund (or any other covered fund controlled by such covered fund), as if the covered

[5] For funds based outside of the United States, this has been interpreted to mean 100 or fewer U.S. holders.

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fund were an affiliate of a member bank for purposes of Section 23A of the BHCA. This prohibition also extends to any affiliates of such banking entity. In this context, "covered transactions" generally includes loans and other extensions of credit to an affiliate, guarantees of an affiliate's obligations, purchases of assets of an affiliate, purchase of, or an investment in, a security issued by an affiliate, and any credit exposure to an affiliate arising from a derivative transactions, repurchase agreements, reverse repurchase agreements, securities lending or securities borrowing transactions.[6]

For example, as a result of the Volcker Rule's Super 23A restrictions, if a banking entity serves as the investment manager or sponsor to a covered fund, that banking entity and any of its affiliates would be prohibited from providing any kind of debt financing to that covered fund and any other covered funds controlled by such fund (which would include the purchase of any debt securities). If a banking entity delegates its responsibility to act as sponsor, investment manager, or investment adviser to an unaffiliated party, it would still be subject to the Super 23A restrictions if the banking entity retains the ability to select, remove, direct, or otherwise exert control over the sponsor, investment manager, or investment adviser designee.

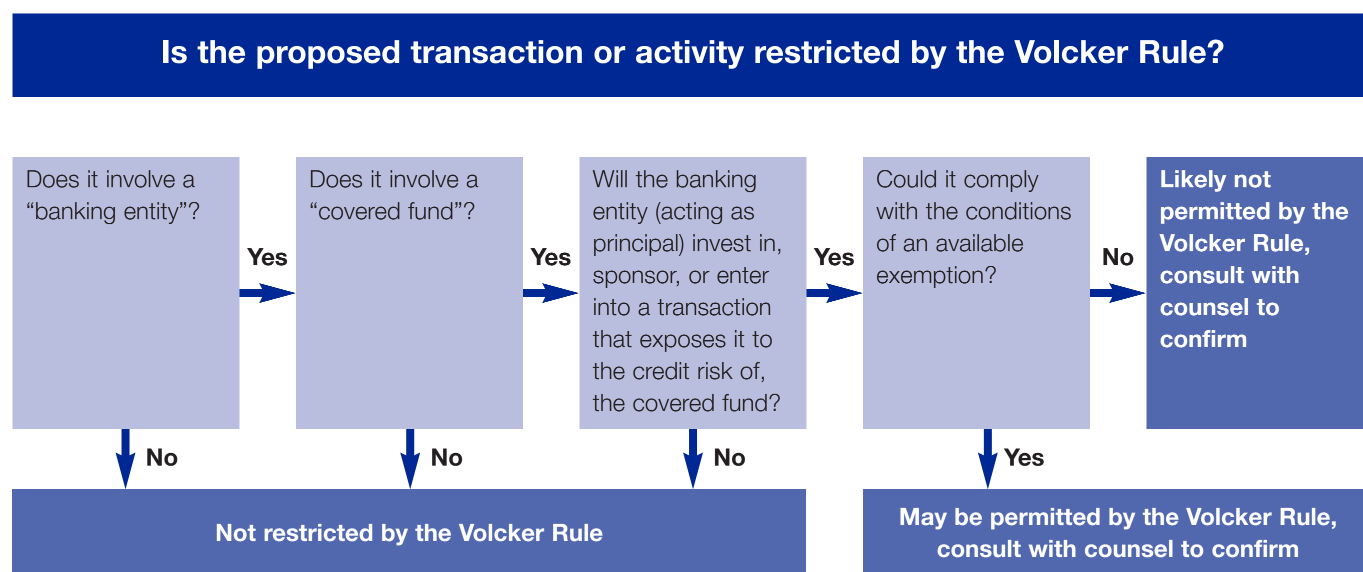
If specified conditions are met, however, a banking entity may own or sponsor a covered fund in connection with:

- organizing and offering the fund;
- underwriting or market making-related activities;
- specified risk-mitigating hedging;
- activities that occur solely outside of the United States; or
- insurance company activities.

Note that these exemptions are not available if the relevant transaction, class of transactions, or activity would:

- involve or result in a material conflict of interest between the banking entity and its clients, customers or counterparties;
- result directly or indirectly in a material exposure by the covered banking entity to a high-risk asset or a high-risk trading strategy[7]; or
- pose a threat to the safety and soundness of the covered banking entity or to the financial stability of the United States.

The following graphic summarises the key steps in assessing whether a proposed structured finance transaction or activity would be restricted by the Volcker Rule.



[6] Prime brokerage transactions are excluded from the Super 23A restrictions.
[7] The Implementing Regulations provide definitions for the terms "high-risk asset" and "high-risk trading strategy", which generally would be implicated if an asset or group of related assets or trading strategy would significantly increase the likelihood that the banking entity, if it held such asset(s) or engaged in such strategy, would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

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Effective date and conformance period

While the Implementing Regulations became effective on 1 April 2014, banking entities will generally have until 21 July 2015 to conform their existing activities and investments with the covered fund prohibitions of the Volcker Rule and the Implementing Regulations[8]. (The period of time between the effective date and the date by which conformance is required is called the "conformance period.") U.S. regulators do, however, expect banking entities to demonstrate good faith efforts to comply with the Volcker Rule during the conformance period – this includes generally not entering into new, non-conforming transactions and developing a plan to address pre-existing transactions that do not conform to the Volcker Rule's prohibitions.

A number of industry participants and U.S. policy makers have expressed concern that the Implementing Regulations would require divestiture by banking entities of securities deemed to be "ownership interests" in collateralised loan obligation vehicles ("CLOs") that would technically constitute "covered funds" under the Volcker Rule. To address this issue, the U.S. Federal Reserve Board has confirmed that it intends to exercise its authority to extend the conformance period for two additional years (to 21 July 2017) with respect to ownership interests in, and sponsorship of, CLOs that are covered funds.[9]

Banking entities that engage in activities covered by the Volcker Rule are required to establish compliance programs to ensure and monitor compliance with the prohibitions and restrictions of the Volcker Rule and the Implementing Regulations.

Practical considerations for structured finance transactions

As noted above, because of the broad scope and geographic reach of the Volcker Rule, it is possible that issuers or other special purpose vehicles ("SPVs") used in many structured finance transactions could technically be considered "covered funds", which would necessitate significant restructuring of any banking entities that sponsor or retain ownership interests in these entities. The following four key questions should be considered in evaluating whether the restrictions of the Volcker Rule apply to the structured finance activity of a non-U.S. financial institution.

1. Does the non-U.S. financial institution, its parent or any of their respective subsidiaries or affiliates directly or indirectly offer banking services in the United States through a branch or subsidiary?

If yes, such a non-U.S. financial institution would likely be considered to be a "banking entity" and therefore subject to the restrictions of the Volcker Rule. If it is not a "banking entity", no further Volcker Rule analysis would be required.

When would a non-U.S. financial institution be a "banking entity" for purposes of the Volcker Rule?

Whether the Volcker Rule would restrict any activities of a non-U.S. financial institution depends on whether it is a "banking entity" – this term generally includes any non-U.S. parent, affiliate or subsidiary of a financial institution that conducts banking operations in the United States. Specifically, the Implementing Regulations define "banking entity" to include the following:

- an insured depository institution organised in the United States;
- a company or institution that controls a U.S. insured depository institution (*i.e.*, a bank holding company);
- a non-U.S. bank with a U.S. branch or agency, and its parent company (if any); or
- an affiliate[10] or subsidiary[11] of any of the above.

For example, pursuant to the third part of this definition, a non-U.S. bank that maintains a U.S. branch would be a "banking entity" for purposes of the Volcker Rule. Pursuant to the fourth part of this definition, the non-U.S. parent company of such a non-U.S. financial institution and each of its affiliates and subsidiaries (world-wide) would also be "banking entities". Each non-U.S. entity shown in the graphic on page 39 would be regulated under the Volcker Rule as a

[8] The U.S. Federal Reserve Board has the authority to extend the conformance period by not more than one year at a time, for a total of not more than three years, if in its judgment, an extension is consistent with the purposes of Section 13 of the BHCA and would not be detrimental to the public interest. At the time the Implementing Regulations were adopted, it extended the conformance period by one year. Accordingly, it has the authority to extend the conformance period by two additional years.

[9] The U.S. Federal Reserve Board's statement regarding its intent to extend the conformance period with respect to CLOs through July 2017 is available here: http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140407a1.pdf.

[10] In this context, "affiliate" means any company that controls, is controlled by, or is under common control with a banking entity. For purposes of this definition, the term "control" tends to be more broadly interpreted by U.S. bank regulators than by the U.S. Securities and Exchange Commission, which uses a similarly worded definition of affiliate. As a result, there are many circumstances in which an entity may be considered an "affiliates" for U.S. bank regulatory purposes but not for U.S. federal securities law purposes.

[11] In this context, "subsidiary" means any company of which 25% or more of the voting shares is directly or indirectly owned, controlled or held (with the power to vote) by a banking entity or any company which a banking entity controls in any manner the election of a majority of its directors.

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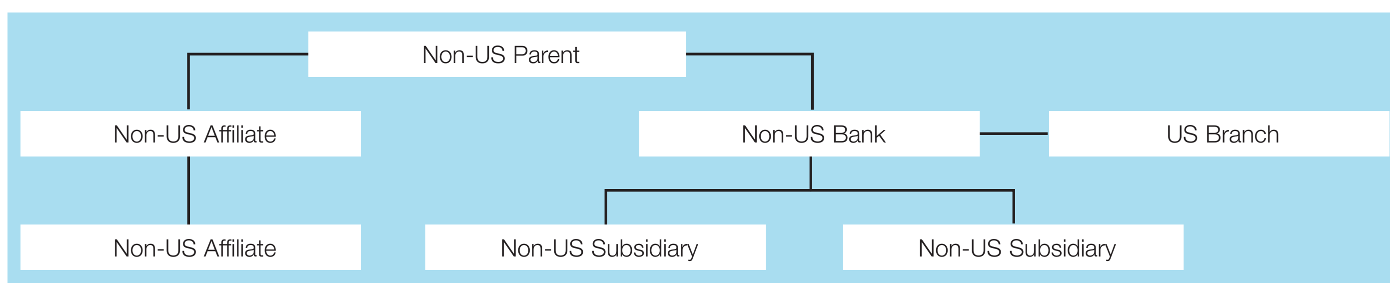

"banking entity" because of the existence of the non-U.S. bank's U.S. branch.

The broad extra-territorial reach of the definition of "banking entity" serves to level the playing field for U.S. banking entities while protecting the U.S. financial system from exposure to the risks of short-term proprietary trading activities by off-shore entities. Non-U.S. banks to which the Volcker Rule does not apply because they do not currently maintain a U.S. branch or subsidiary (but are considering doing so in the future), may also want to give consideration to the Volker Rule's treatment of structured finance transactions with which they are involved to avoid potential issues in commencing U.S. operations at a later date.

2. Does the structured finance transaction involve an SPV that primarily holds financial assets without carrying on any active business?

If yes, the SPV may be considered a "covered fund" to which the prohibitions of the Volcker Rule would apply unless an exclusion or exemption is available. If the SPV qualifies for an exclusion from the definition of "covered fund", further consideration of limitations on activities or transactions with the SPV pursuant to the Volcker Rule would not be required. Importantly, an SPV that could be a "covered fund" because it relied on Section 3(c)(1) or Section 3(c)(7) for an exemption under the Investment Company Act when it was structured would not be a "covered fund" if it also is eligible for another exemption from regulation as an "investment company" under the Investment Company Act (such as Sections 3(c)(5)(A) or 3(c)(5)(C), relating to vehicles primarily holding accounts receivable or real estate mortgages, respectively, or Rule 3a-7, relating to certain securitization vehicles).

When would an SPV for a structured finance transaction be a "covered fund"?

The legislative intent of the Volcker Rule was to restrict investments by banks in entities that principally engage in proprietary trading: in particular, entities commonly understood to be "private equity funds" or "hedge funds". As these terms had no prior specific regulatory definition in the United States, however, creating a definition of "covered fund" broad enough to capture all activity intended to be regulated by the Volcker Rule presented a challenging task. To remain unregulated in the United States, most private equity funds and hedge funds rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, so Congress chose to reference these two sections to define these terms for purposes of the Volcker Rule. The Agencies then followed this approach by specifying in the Implementing Regulations that a "covered fund" is an entity that would be an "investment company" subject to regulation under the Investment Company Act *but for* the exemptions provided by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. (In addition, the Implementing Regulations include specified commodity pools that utilise similar private fund-like structures in the definition of "covered fund".)

Although the definition of "investment company" is complex, it essentially includes any entity that is primarily engaged in the business of investing or trading in securities.[12] SPVs used to facilitate structured finance transactions typically risk being considered an "investment company" under the Investment Company Act – unless they qualify for an exemption (such as provided by Section 3(c)(1) or Section 3(c)(7)) – because they only hold financial assets without carrying on any active business operations. Other Investment Company Act exemptions that may apply to structured finance transactions include Section 3(c)(5)(A), Section 3(c)(5)(C) or Rule 3a-7. If any of these alternative Investment Company Act exemptions are available to an SPV, it would likely not be considered a "covered fund" – thus avoiding Volcker Rule restrictions.

The Implementing Regulations also deem a fund that is organized and offered solely outside the United States to be a "covered fund" – even if it does not need to rely on Sections 3(c)(1) or 3(c)(7) under

[12] As used in the Investment Company Act, the term "securities" is broadly construed to mean virtually any financial asset.

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the Investment Company Act to avoid regulation under that act – if:

- a banking entity that is located in or organized under the laws of the United States (which would include a U.S. subsidiary of a non-U.S. financial institution) has an ownership interest in or sponsors the fund, either directly or indirectly through a non-U.S. subsidiary; and
- the fund is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.[13]

Certain wholly-owned subsidiaries, joint ventures and acquisition vehicles (potentially including SPVs in structured finance transactions), as well as SEC-registered investment companies and business development companies, are excluded from the definition of "covered fund".[14] In addition, certain non-U.S. public funds, qualifying loan securitisations, qualifying asset-backed commercial paper conduits and qualifying covered bonds are excluded from the definition of "covered fund".

3. If the structured finance transaction does involve a "covered fund", does the non-U.S. financial institution (acting as principal) propose to invest in, sponsor, or enter into a transaction that exposes it to the credit risk of, the covered fund?

Given the broad definitions of the terms "ownership interest" and "sponsor", it will be important to review carefully the particular facts of any given transaction, including all interests in, and all rights with respect to, an entity that appears to be a covered fund, to determine whether any of these interests constitute an "ownership interest" for purposes of the Volcker Rule. If there is an ownership interest or sponsorship, the proposed investment, sponsorship or other transaction may run afoul of Volcker Rule prohibitions, absent an available exception. Even when an exception for a proposed investment or sponsorship in a covered fund is available to a banking entity under the Implementing Regulations, the Super 23A restrictions may operate to prohibit any ancillary or related "covered transactions".

4. Could the proposed activity or transaction comply with the conditions of an available exemption?

If an issuer or other entity in a structured finance transaction would technically be considered a "covered fund" (as described above), if one of the various exemptions contained in the Implementing Regulations is available, the Volcker Rule would not apply and would therefore not prohibit the proposed activity or transaction if it would involve a banking entity acquiring / holding an ownership interest in or sponsoring such an entity.

Which Volcker Rule exemptions are most relevant to structured finance transactions?

The Implementing Regulations provide three separate exemptions from the definition of "covered fund" that are useful for a range of entities used in structured finance transactions. To the extent these exemptions would cause a structured finance vehicle not to be a "covered fund", the Volcker Rule's Super 23A restrictions would not apply either and any ancillary transactions between a banking entity and such vehicle would be permissible under the Volcker Rule.

In fact, many structured finance vehicles (especially SPVs for residential mortgage backed securities, commercial mortgage backed securities and credit card and other consumer asset securitisations) may qualify for one of the alternative Investment Company Act exemptions noted above and would therefore not need to qualify for one these three exemptions from the definition of "covered fund". Accordingly, it will be extremely important in any structured finance transaction to initially determine whether an exemption from the definition of "investment company" other than those contained in Sections 3(c)(1) or 3(c)(7) are available. Where an SPV in a structured finance transaction must rely on either Sections 3(c)(1) or 3(c)(7) for an exemption from the definition of "investment company" under the Investment Company Act, it may still avoid regulation under the Volcker Rule if one of the following exemptions in the Implementing Regulations is available:

Qualified loan securitisations. The Implementing Regulations exclude specified loan securitisations ("qualified loan securitisations") from the definition of covered fund. A "loan securitisation" is defined as a transaction involving an issuing entity for asset-backed securities that meets the conditions of the rule and

[13] The Implementing Regulations expressly provide that such a non-U.S. fund will not be deemed a covered fund if, were the non-U.S. fund subject to the U.S. securities laws, it could rely on an exclusion or exemption from the definition of investment company under the Investment Company Act other than the exclusions set forth in Sections 3(c)(1) and 3(c)(7).

[14] To the extent such an entity were an affiliate or subsidiary of a "banking entity", it would likely be a "banking entity" and, though not itself a "covered fund", would nevertheless need to comply with the prohibitions of the Volcker Rule applicable to banking entities.

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the assets or holdings of which are comprised solely of: (A) loans (as defined in the Implementing Regulations)[15]; (B) rights or other assets (i) designed to assure the servicing or timely distribution of proceeds to holders of such securities or (ii) related or incidental to purchasing or otherwise acquiring and holding the loans, provided that each asset is a permitted security meeting specified requirements ("servicing assets"); (C) interest rate or foreign exchange derivatives that meet specified requirements; and (D) special units of beneficial interest and collateral certificates that meet specified requirements. In addition, this entity may also hold the following "permitted securities" (often also referred to as eligible investments): (i) cash equivalents designed to assure the servicing or timely distribution of proceeds to holders of such securities; and (ii) securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities.

A loan securitisation is not permitted to hold any of the following "impermissible assets": (i) a security, including an asset-backed security, or an interest in an equity or debt security other than a permitted security described below; (ii) a derivative other than a permitted derivative described below; or (iii) a commodity forward contract.

Servicing assets are permissible in a qualified loan securitisation only to the extent that they arise from the structure of the loan securitisation or from the loans supporting a loan securitisation. If servicing assets are sold and securitised in a separate transaction, they will not qualify as permissible holdings for the loan securitisation exclusion. Servicing assets do not include securities or derivatives other than permitted securities and permitted derivatives as described below.

A loan securitisation may hold the following permitted securities: (i) cash equivalents[16] and (ii) securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities (*i.e.*, securities received in bankruptcy in exchange for loans).

A loan securitisation may hold only interest rate or foreign exchange derivatives that meet the following requirements: (i) the written terms of the derivative directly relate to the loans, the asset-backed securities, or the servicing assets; and (ii) the derivatives reduce the interest rate and/or foreign exchange risks related to the loans, the asset-backed securities, or the contractual rights or the servicing assets. The "directly relate" requirement is intended to quantitatively and qualitatively limit the use of derivatives permitted in qualified loan securitisations. The Agencies have noted that they expect that neither the total notional amount of directly related interest rate derivatives nor the total notional amount of directly related foreign exchange derivatives should exceed the greater of either (i) the outstanding principal balance of the loans supporting the asset-backed securities or (ii) the outstanding principal balance of the asset-backed securities. In addition, the derivatives held by a loan securitisation must be related to the types of risks associated with the underlying assets and may not be derivatives designed to supplement income based on general economic scenarios, income management or unrelated risks, such as credit default swaps.

The Implementing Regulations also permit qualifying loan securitisations to hold special units of beneficial interest ("SUBIs") and collateral certificates, provided that four conditions are met:

- the SPV that issues the SUBI or collateral certificate to the issuing entity for the loan securitisation meets specified requirements;
- the SUBI or collateral certificate is used for the sole purpose of transferring to the issuing entity for the loan securitisation the economic risks and benefits of the assets that are otherwise permissible for loan securitisations under the Implementing Regulations and does not directly or indirectly transfer any interest in any other economic or financial exposure;
- the SUBI or collateral certificate is created solely to satisfy legal requirements or otherwise facilitate the structuring of the loan securitisation; and
- the SPV that issues the SUBI or collateral certificate and the issuing entity for the loan securitisation are established under the direction of the same entity that initiated the loan securitisation.

In adopting the Implementing Regulations, the Agencies recognised that securitisation structures that use these types of intermediate asset-backed securities (such as master trust structures) are essentially loan securitisation transactions.

[15] The Implementing Regulations define "loan" for these purposes to mean "any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative." A loan securitisation must own the loan directly and not through a synthetic exposure, such as a credit default swap. A securitisation that owns a tranche of another loan securitisation will not qualify as a loan securitisation.

[16] The Agencies interpret "cash equivalents" to mean high-quality, highly liquid, short-term investments whose maturity corresponds to the securitisation's expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities.

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Qualified ABCP conduits. The Implementing Regulations also exclude certain qualifying asset-backed commercial paper ("ABCP") conduits from the definition of "covered fund." ABCP is a type of short-term asset-backed security that is typically issued by a special purpose vehicle (commonly referred to as a "conduit") sponsored by a financial institution or other entity to provide an efficient form of financing to their customers. ABCP issued by the conduit is supported by a managed pool of assets, typically including automobile loans, commercial loans, trade receivables, credit card receivables, student loans, and other loans in addition to asset-backed securities supported by such assets. The composition of the assets held by a conduit will generally change over the life of the entity as different customers of the sponsor are added to, or removed from, the program. ABCP is typically short term, and the conduit's liabilities are replaced or refinanced (or "rolled") at regular intervals so that ABCP conduits are generally funding longer-term assets with shorter-term liabilities. Because of their unique structure (i.e., involving a dynamic pool of diverse assets), conduit issuers of ABCP typically rely on the exemption from "investment company" status contained in Section 3(c)(1) of the Investment Company Act and so would otherwise be treated as "covered funds".

The Implementing Regulations provide the following requirements for an ABCP conduit to qualify for the exclusion:

- the ABCP conduit must only hold (i) loans or other assets that would be permissible in a qualified loan securitisation and (ii) asset-backed securities that are supported solely by assets permissible for a qualified loan securitisation that are acquired as part of the initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the asset-backed securities;
- the ABCP conduit must only issue short-term ABCP with a maximum term of 397 days (along with any residual interests issued); and
- the ABCP conduit must enter into an agreement with a "regulated" liquidity provider to provide the ABCP conduit with 100% liquidity coverage.

Qualified covered bonds. The Implementing Regulations specifically exclude from the definition of "covered fund" certain entities that own or hold assets that cover the payment obligations of covered bonds issued by non-U.S. banks. Covered bonds are full recourse debt instruments that are also secured or "covered" by a pool of high-quality collateral, such as residential or commercial mortgage loans or public sector loans. Many of these covered bond structures utilise an SPV that holds the fixed or dynamic collateral pool and which could be considered a covered fund to the extent that the SPV would be considered an "investment company" for purposes of the Investment Company Act but for the exclusion in Sections 3(c)(1) or 3(c)(7) of the Investment Company Act. For various reasons, covered bonds are not currently issued by U.S. financial institutions.

In order to qualify for the covered bond exclusion, the assets or holdings in the cover pool must only consist of loans or other assets that would be permissible in a qualified loan securitisation. As with the exclusion for ABCP conduits, the Agencies take a consistent approach in creating an exclusion aligned with the Dodd-Frank Act's allowance for "loan" securitisations (found in Section 13(g)(2) of the BHCA) and which avoids, what in their view would be an inappropriate expansion of the exclusion beyond the scope of the definition of "loan" in the Implementing Regulations.

This exclusion is only available to covered bonds issued by entities that meet the definition of "foreign banking organization" under the Implementing Regulations. The covered bond may be issued directly by the non-U.S. bank or by an SPV that owns a permitted cover pool. In either case, the payment obligations of the debt obligation must be fully and unconditionally guaranteed. If the covered bonds are issued by a non-U.S. bank, the structure will qualify for the exclusion under the Implementing Regulations if the payment obligations are fully and unconditionally guaranteed by the SPV that owns the permitted cover pool.

If the covered bonds are issued by the SPV that owns a permitted cover pool, the structure will qualify for the covered bond exclusion under the Implementing Regulations only if (i) the payment obligations are fully and unconditionally guaranteed by the non-U.S. bank and (ii) the SPV issuer is a wholly-owned subsidiary of such non-U.S. bank. This type of covered bond structure, in which an SPV holds the cover pool and issues securities that are fully and unconditionally guaranteed by a non-U.S. bank, may also be able to rely on the loan securitisation exclusion if it meets all of the requirements of that exclusion.

The exclusion for covered bonds in the Implementing Regulations would not be available to covered bond structures in which the cover pools include residential mortgage-backed securities or other non-loan assets (even if the issuers are

permitted by their respective laws to own these types of assets as part of the cover pool). This is part of the Agencies' deliberate approach to avoid what they perceive as a broadening the definition of "loan". The Agencies also state that allowing cover pools to hold securities and other assets would provide unequal treatment of covered bonds as compared to a loan securitisation sponsored by a U.S. bank.

Does the Volcker Rule offer any accommodations for transactions that do not involve any activities in the United States?

In the event that a non-U.S. structured finance transaction does not neatly fit into one of alternative Investment Company Act exemptions (*e.g.*, Section 3(c)(5)(A), Section 3(c)(5)(C) or Rule 3a-7) or the three above-described exemptions from the definition of "covered fund", the Implementing Regulations do additionally provide two separate accommodations for non-U.S. activities in connection with the covered fund prohibitions.

First, a "foreign public fund" is excluded from the definition of "covered fund" if it meets the following conditions:

- the fund is organised or established outside of the United States, authorised to offer and sell ownership interests to retail investors[17] in its home jurisdiction, and sells its ownership interests predominantly through one or more non-U.S. public offerings;
- in connection with each public offering of the fund's ownership interests in any jurisdiction outside the United States to investors, including retail investors, such public offering complies with all applicable requirements in the jurisdiction in which it is being made, such public offering does not restrict availability to investors having a minimum level of net worth or net investment assets, the fund has submitted offering disclosure documents to the appropriate regulatory authority in such jurisdiction, and such documents are publicly available; and
- if the fund is sponsored by a U.S. Banking Entity, either directly or indirectly through a non-U.S. subsidiary, then the fund's ownership interests are sold predominantly (*i.e.*, 85% or more of the fund's interests are sold) to persons other than the fund, the U.S. Banking Entity and their respective affiliates, directors and employees.

To qualify for this exclusion (or the following exception), banks will want consider adopting more restrictive selling restrictions that would eliminate flow back into the United States of Regulation S-only securities of entities that would be covered funds if held by U.S. Investors.

Second, the Implementing Regulations provide that the Volcker Rule prohibition does not apply to the acquisition or retention of an ownership interest in, or the sponsorship of, a covered fund by a non-U.S. banking entity (*i.e.,* a banking entity that is not organised or directly or indirectly controlled by a banking entity that is organised under the laws of the United States) so long as –

- the non-U.S. banking entity's activity or investment is conducted pursuant to Section 4(c)(9) or Section 4(c)(13) of the BHCA (which generally exempt certain non-U.S. banking organizations from restrictions on their non-banking activities where the exemption would not be substantially at variance with the BHCA's purposes and would be in the public interest);
- no ownership interest in the covered fund is offered for sale or sold to a resident of the United States; and
- the activity or investment occurs solely outside the United States.

This exception is often referred to as the "SOTUS" (solely outside the United States) exception, and may be particularly helpful in cases where a covered fund is organised in the United States but is offered only to non-U.S. persons. While compliance with the conditions of the SOTUS exception permits a banking entity to invest in a covered fund, the Volcker Rule's Super 23A restrictions would apply to restrict any ancillary "covered transactions" between the banking entity and that covered fund.

Conclusion

While the Implementing Regulations became effective on 1 April 2014, banking entities will generally have until 21 July 2015 to conform their existing activities and investments with the covered fund prohibitions of the Volcker Rule and the Implementing Regulations. During the conformance period, U.S. regulators generally expect banking entities to demonstrate good faith efforts to comply with the Volcker Rule during the conformance period – this includes generally not entering into new, non-conforming transactions and developing a plan to address pre-existing transactions that do not conform to the Volcker Rule's prohibitions.

[17] While the term "retail investors" is not defined in the Implementing Regulations, it generally refers to members of the general public who do not possess the level of sophistication and investment experience typically found among institutional investors, professional investors or high net worth investors of the type that qualify as permitted investors in complex investments or private placements in various jurisdictions.

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When evaluating whether the restrictions of the Volcker Rule apply to the structured finance activity of a non-U.S. financial institution, the following four key questions should be considered:

1. ***Does the non-U.S. financial institution, its parent or any of their respective subsidiaries or affiliates conduct any U.S. banking operations?***

   If yes, such a non-U.S. financial institution is likely to be considered a "banking entity" subject to the restrictions of the Volcker Rule.

2. ***Does the structured finance transaction involve a special purpose vehicle that primarily holds financial assets without carrying on any active business?***

   If yes, the SPV may be considered a "covered fund" to which the prohibitions of the Volcker Rule would apply unless an exemption or exception is available.

3. ***If the structured finance transaction does involve a "covered fund", does the non-U.S. financial institution (acting as principal) propose to invest in, sponsor, or enter into a transaction that exposes it to the credit risk of, the covered fund?***

   If yes, the proposed investment, sponsorship or other transaction may run afoul of Volcker Rule prohibitions, absent an available exception.

4. ***Could the proposed activity or transaction comply with the conditions of an available exemption?***

   If yes, the structured finance activity or transaction would not be prohibited by the Volcker Rule, as long as specified conditions continue to be satisfied.

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Acknowledgements

We would like to thank the following people for their contributions to this publication:

Jeff Berman
Andrew E. Bryan
Lewis Cohen
Steve Curtis
Andrew Forryan
Rebecca Hoskins
Kevin Ingram
Kathryn James
Emma Matebalavu
Cameron Saylor
Martin Sharkey
Christopher Walsh

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J201405120045275