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07 November 2012

Jonathan Faull
Director-General
Directorate-General Internal Market and Services
European Commission
1049 Brussels
Belgium

Dear Mr Faull

Issue 168: the securitisation risk retention rules

As you know, the role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risk and to consider how such issues should be addressed.

The FMLC takes the view, explored below, that legal uncertainty may arise from the securitisation risk retention rules for credit institutions which are set out in Article 122a of Directive 2006/48/EC as amended by Directive 2009/111/EC (the "Directive").[1] The FMLC is given to understand that this uncertainty may be having a detrimental effect on, in particular, the market for collateralised loan obligations ("CLO") in Europe: credit institutions are being discouraged from entering the CLO market.[2]

The FMLC is further given to understand that the detrimental effect of the uncertainty would be mitigated if credit institutions were able to rely on guidelines published by the Committee on European Banking Supervisors, now the European Banking Authority or the "EBA" (the "Guidelines").[3]

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1 Consolidated text at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20111209:EN:PDF.

2 A CLO is a type of debt security (generally issued by a special purpose entity) which is created to securitise corporate loans.

3 The Guidelines, which were published in December 2010, can be found at http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf.

Q&A responses from the EBA, published in September 2011, appear to confirm the interpretation of the Directive given in the Guidelines. The Q&A responses can be accessed at http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2011/EBA-BS-2011-126-rev1(QA-on-guidelines-Artt122a).pdf.

In this context, the FMLC believes that your expressing a view as to the reliability of the interpretation of the Directive which is provided by the Guidelines could increase certainty in the market.

Article 122a of the Directive

Article 122a of the Directive creates a restriction on acquiring exposure to the credit risk of a securitisation without the "originator", "sponsor" or "original lender" explicitly disclosing that it would retain, on an on-going basis, a material net economic interest of not less than five percent in the securitisation. The restriction applies to European credit institutions which are not acting as the "originator", "sponsor" or "original lender" for the relevant securitisation.[4]

In the context of a CLO it appears uncertain how the requirement can be fulfilled. This is because, as is explored below, there may not be any party to a CLO transaction who fulfils the definition of "originator", "sponsor" or "original lender".

The definition of "originator"

Article 4(41) of the Directive provides that "originator" means either (a) an entity which, either itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or (b) an entity which purchases a third party's exposures onto its balance sheet and then securitises them.

In practice, however, a party to the original agreement, or a third party purchaser, is unlikely to have any link to a CLO.

The definition of "sponsor"

Article 4(42) to the Directive provides that "sponsor" means a credit institution other than an originator credit institution that establishes and manages an asset backed commercial paper programme or other securitisation scheme that purchases exposures from third party entities. According to the Directive, a "sponsor" is a "credit institution" in the meaning of the Directive which establishes and manages a securitisation. Article 4(1) provides that "credit institution" means (a) an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account; or (b) an electronic money institution within the meaning of Directive 2000/46/EC.

In the case of a CLO, it will be an asset manager who establishes and manages the securitisation but an asset manager cannot qualify as a credit institution. For this reason, there will no "sponsor" in a CLO transaction.

The definition of "original Lender"

Original lender is not defined in the Directive. Paragraph 23 of the Guidelines, however, provides that "original lender and the originator will typically be the same entity". For the reasons stated above, therefore, there will usually be no "original lender" in a CLO transaction.

The Guidelines

The Guidelines acknowledge that there are circumstances in which it is not possible to identify a party to a securitisation which conforms to the definition of "originator", "sponsor" or "original lender". They go on to suggest, in effect, that the approach to take in such a situation is to ensure that there be a party to the securitisation (i) whose interests are aligned with "interests of investors" and (ii) who has an interest of not less than five percent in the transaction.[5]

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[4] As discussed further below, there are equivalent provisions in European law which affect other investors, such as alternative investment fund managers.

[5] See paragraph 25 of the Guidelines.

For example, a professional investment manager, who acts as the "sponsor" of a deal in a commercial sense and who selects and manages the loans in the CLO, cannot hold the requisite five percent stake but has an interest in the performance of the CLO which is closely aligned with investors' and is remunerated by reference to the yield of the CLO to investors.

Impact of the uncertainty

As referred to above, discussions with market participants suggest that uncertainty in the securitisation risk retention rules is having a negative effect on the CLO market because it is discouraging credit institutions from taking on exposure to CLOs. The market being able to rely on the Guidelines might reduce this negative effect.

Further, the FMLC believes that implementation of the Alternative Investment Fund Managers Directive may, by introducing provisions equivalent to those in the Directive,[6] extend the effect of the uncertainty described above from credit institutions to alternative investment fund managers. Similarly, Article 135(2) of the Solvency II Directive introduces provisions equivalent to those in the Directive which may extend the uncertainty further.[7]

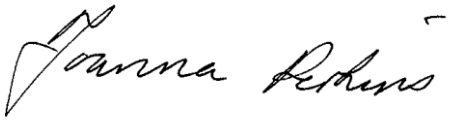
The FMLC also notes that, while this letter focuses on the CLO market, the uncertainty described may present difficulties with regard to types of securitisation beyond CLOs.

In light of the foregoing, the FMLC is of the view that your providing confirmation as to the reliability of the interpretation of the Directive which is provided by the Guidelines could increase legal certainty for the market.

Please find enclosed a copy of a letter which has been sent to Andrea Enria, Chairperson of the EBA, regarding the matters raised in this letter.

I would be delighted to discuss the issues raised in this letter further. Please do not hesitate to contact me should you require any further information or you would like to explore the possibility of a meeting.

Yours sincerely



Joanna Perkins
FMLC Director

Enc: Letter to Andrea Enria

6 Article 17(a) of Directive 2011/61/EU.

7 Directive 2009/138/EC.

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07 November 2012

Andrea Enria
Chairperson
European Banking Authority
Tower 42 (level 18)
25 Old Broad Street
London EC2N 1HQ

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The FMLC is further given to understand that the detrimental effect of the uncertainty would be mitigated if credit institutions were able to rely on guidelines published by the Committee on European Banking Supervisors, now the European Banking Authority or the "EBA" (the "Guidelines").[3] Your confirming that, in the continuing view of the EBA, the interpretation provided by the Guidelines is correct could, the FMLC believes, increase certainty in the market.

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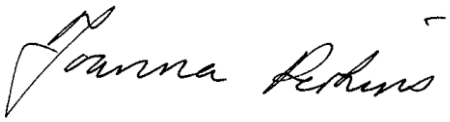

Joanna Perkins
FMLC Director

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