FSB FINANCIAL STABILITY BOARD

Evaluation of the Effects of the G20 Financial Regulatory Reforms on Securitisation: Consultation report

Response to Consultation

Allen Overy Shearman Sterling LLP

1. **Preliminary findings: Does the report draw the appropriate inferences about the extent to which the securitisation reforms have achieved their objectives? Is there other evidence on the effects of the reforms to complement the preliminary findings of the report?**

2. **Analytical approach: Are the descriptive analyses used to evaluate the effects of the securitisation reforms appropriate? Are there other such analyses to consider? What types of empirical analysis based on available data could inform the evaluation?**

3. **Trends: Are the securitisation market trends presented in this report adequate given the scope of the evaluation? Are there other important trends that should be included and, if so, what additional data sources could be used for this purpose?**

4. **Relevant reforms: Does the report appropriately describe the key aspects of the design and jurisdictional implementation of the BCBS and IOSCO reforms for analysing their impact on securitisation markets? Are there other important aspects of these reforms that should be considered for inclusion?**

5. **Other reforms: Does the report accurately identify other G20 and domestic financial reforms that are most relevant for securitisation markets? Are there other reforms that should be considered in terms of their impact on market participants?**

6. **Conceptual framework: Does the report adequately explain the objectives, transmission channels and expected outcomes of the securitisation reforms? What other metrics to assess the impact of the reforms should be considered?**

7. **Resilience metrics for the CLO market: Does the report accurately describe the evolution of resilience indicators for the CLO market? To what extent can the evolution of these indicators be attributed to the reforms?**

8. **Risk retention in CLOs: Does the report accurately describe risk retention practices in the CLO market before and after the reforms? What additional analysis could be included to assess the effectiveness of risk retention in CLOs across FSB jurisdictions, including on how financing of risk retention deals by third party investors impacts effectiveness?**

Dear Sir or Madam

We refer to your consultation report titled "Evaluation of the Effects of the G20 Financial Regulatory Reforms on Securitisation" dated 2 July 2024 (the "Consultation Report"). We act as legal advisors for arrangers, sponsors and originators in the Global CLO market and are writing to respond to question 8 (Risk retention in CLOs) in your "Questions for consultation" and will, in particular, address the following:

"What additional analysis could be included to assess the effectiveness of risk retention in CLOs across FSB jurisdictions, including on how financing of risk retention deals by third party investors impacts effectiveness?"

1. Introduction

Section 4.2 of the Consultation Report suggests that, in CLOs where risk retention is held by an entity other than the relevant "sponsor" of the securitisation, there is a concern about whether the policy objective of risk alignment between investors and the party establishing the CLO is achieved. The Consultation Report states that risk retention vehicles are set up to "attract third-party investors such as pension funds or family offices" as investors and that this "practice might not be fully aligned with the goals of risk retention regulation because in many cases the vehicle does not belong to the same corporate group as the CLO manager…".

This analysis erroneously assumes that the policy objectives for risk retention are best met if the CLO manager (the "sponsor" in a CLO) is the risk retainer. As a starting point, as we explain below, the policy concerns around ensuring risk alignment should not apply in the context of a managed CLO.

However, given the Securitisation Regulation (as it applies in the EU and the UK, respectively) does require risk retention to be held in respect of CLOs, a third party risk retainer which is involved in the establishment of the CLO and which has contributed a majority of the assets to the CLO (a "Third Party Originator") should be an eligible risk retainer.

Further, the Consultation Report mischaracterises Third Party Originators active in the CLO market as shell vehicles for which there should be a "look-through" to third party equity investors. As we explain below, Third Party Originators operating in the CLO market are entities of substance for which there should be no "look-through".

2. Background

There are, broadly speaking, two types of CLOs: (a) "balance sheet CLOs", where the assets are acquired by the CLO from the balance sheet of an entity such as a bank for the purposes of obtaining funding or managing risk, and (b) "managed CLOs" (where the assets

are acquired at the direction of an investment manager on behalf of the CLO from different entities in the market). Balance sheet CLOs are, for present purposes, akin to traditional securitisations and, in that respect, can be excluded from this discussion. Managed CLOs, on the other hand, are not traditional securitisation but rather are effectively an asset management exercise, which adopts some legal and structuring aspects of securitisations, namely credit tranching. This response is therefore limited to “managed CLOs” and references to “CLOs” should be construed accordingly.

CLOs currently play a critical role in funding the European loan markets and the European CLO market collectively constitutes the largest buyer of European syndicated loans. The operation of the European corporate loan market is therefore fundamentally reliant on the participation of European CLOs in order to ensure the flow of funding from the capital markets to companies seeking funding. It is worth noting that in Europe at present, CLOs are predominantly active in the funding of debt to larger borrowers in the syndicated loan market. However, in the US there is a very significant middle-market and private capital CLO market, providing direct lending to smaller companies, including SMEs. The European CLO market is currently in the process of developing a similar mid-market and private capital CLO market, which will increase available funding to smaller European companies.

The way CLOs acquire assets makes them fundamentally different to more traditional securitisations in that, unlike traditional securitisations, in CLOs there is a separation between the origination of the underlying loan assets and the establishment of the CLO. Loan assets are originated in the usual way by original lenders (such as banks) in the European loan market. CLO managers acquire such assets and pool them into an investment vehicle. CLOs then issue tranched securities to capital market investors and, in doing so, give such investors broad exposure to the corporate loan markets and the investment management expertise of the manager. Therefore, CLOs are not an example of an originate-to-distribute model whereby interest alignment between the originators or original lenders of the assets on the one hand and investors in the CLO on the other hand is necessary for investor protection. They are an investment management model.

This distinction between CLOs and traditional securitisations is the reason that, with respect to the similar risk retention rules in the US, the US Court of Appeals for the District of Columbia Circuit ruled that collateral managers of “open market CLOs” (described in the judgment as CLOs where assets are acquired from “arms-length negotiations and trading on an open market”) are not “securitizers” or “sponsors” under Section 941 of the Dodd-Frank Act and, therefore, are not subject to the U.S. risk retention rules (the "LSTA Decision").

Our view is that a similar exemption to the European risk retention rules should apply for European CLOs. The role of a CLO manager in selecting, acquiring and managing assets is more akin to the role played by a fund manager or an asset manager. Given there is no requirement for fund managers and asset managers to hold risk retention, there should similarly be no requirement for risk retention where European CLOs are concerned. Like fund managers and asset managers, CLO managers are incentivised by fees, including incentive fees paid pari passu with subordinated noteholder distributions.

Notwithstanding our view expressed above, the Securitisation Regulation does require risk retention to be held in respect of European CLOs. The question then arises as to which

entity should be an eligible risk retainer. Where there is no Third Party Originator in a CLO structure, we agree that the CLO manager would be the most appropriate entity to act as risk retainer as it establishes and manages the CLO. Where a Third Party Originator is structurally involved in a CLO, it should be a legitimate risk retainer and is arguably a more appropriate risk retainer than the CLO manager.

3. Third Party Originators

By way of background, Third Party Originators in the CLO market are typically debt origination platforms established by CLO managers, with the purpose of gaining a broad exposure to the corporate credit markets. The structure of these platforms generally involves:

(a) establishment as substantive credit businesses, with substantive corporate governance in the form of professional investment committees and boards with credit investment professionals and formal advisory arrangements with a debt management sponsor;

(b) the raising of significant equity capital from sophisticated institutional investors seeking exposure on a managed and leveraged basis to the corporate loan market; and

(c) execution of a detailed investment strategy involving: (i) direct investment in portfolios of corporate loans; and (ii) utilisation of revolving bank financings, bank warehouse facilities and/or the CLO market as a means of obtaining leverage on those corporate loans, so as to achieve target risk-adjusted returns.

A principal way such platforms obtain leverage on their investments is by way of utilising the CLO market. To elaborate on the use of the CLO market, a typical origination platform would purchase corporate loans and periodically make investment decisions to leverage its interests in certain of these corporate loan portfolios by selling portfolios of such loans to CLOs established by it. The originator typically retains the subordinated interests in these CLOs (constituting a horizontal risk retention interest) while more senior tranches are sold to investors in the capital markets. In doing so, the originator obtains an indirect leveraged investment in the corporate loans it securitises and frees up capital to increase the volume of corporate loans it can invest in. In some cases, the originator may instead acquire and retain a portion of the more senior tranches and thereby retain a vertical risk retention interest, seeking financing on the rated portion of such vertical interest by way of permissible risk retention financing arrangements.

4. Why a Third Party Originator should be an eligible risk retainer

(i) Risk alignment

The Securitisation Regulation specifies that an entity can only qualify as an "originator" (and therefore an eligible risk retainer) for a securitisation if "it has established the … securitisation and has contributed more than 50 % of the total securitised exposures measured by nominal value at origination".

This necessarily means that a Third Party Originator would have contributed the majority of the assets held by the CLO and co-established the CLO alongside the CLO manager. This makes a Third Party Originator a more appropriate risk retainer than the CLO manager

where we are considering the policy objective of risk alignment between investors and asset originators. In contrast, the CLO manager is merely selecting, acquiring and managing the assets.

(ii) A "look-through"

The Consultation Report implies that there should be a "look-through" to the equity investors in a Third Party Originator. The fact that some (or even all) of a Third Party Originator's equity investors are third parties and not part of the CLO manager is a red herring since every company established, including any given CLO manager, has its own investors which are often outside its operating group.

If the entity purporting to hold risk retention was merely a riskless intermediary (i.e. not a substantive entity which holds risk and can absorb losses), then a "look-through" to third party investors would be more appropriate. However, as explained above, Third Party Originators operating in the CLO market are entities with sufficient real substance as demonstrated by the fact that they operate for purposes consistent with a broader business enterprise and/or through the existence of a business strategy and an independent capacity to pay based on a material amount of non-securitisation and/or retention related assets and income.

5. Conclusion

From a policy perspective, CLOs should not be subject to the European risk retention rules contained in the Securitisation Regulation. However, to the extent they are, both CLO managers and Third Party Originators should be eligible retainers. In fact, where Third Party Originators are involved in the establishment of a CLO, having risk alignment between such Third Party Originators and the investors in a CLO is more effective in achieving the goal of investor protection than having risk alignment between the CLO manager and the investors in a CLO.

6. Other general comments on the scope of application of the Securitisation Regulation and its wider impact on securitisation markets including CLOs

As an additional point, we also wanted to make a general note about the scope of the Securitisation Regulation.

As noted above, managed CLOs are not traditional securitisations but rather are effectively asset management exercises, which adopt some legal and structuring aspects of securitisations, namely credit tranching.

Therefore, we also wish to draw the FSB's attention to the fact that there is a material difference between the scope of certain EU and non-EU securitisation reforms in relation to the non-prudential (i.e. unrelated to regulatory capital requirements) regulation of securitisations (such as risk retention requirements), which is not fully acknowledged in the FSB consultation report.

While outside Europe (e.g. in the U.S.) any risk retention, disclosure or transparency reforms apply only to certain (more narrowly defined) ABS products, the Securitisation Regulation brings in scope any transaction that meets the very wide definition of "securitisation" that

turns on there being credit risk tranching, payment dependence upon the performance of the exposure or pool of exposures, subordination of tranches determining the distribution of losses during the ongoing life of the transaction, with an exemption for transactions that demonstrate certain "specialised lending" characteristics. This results in the Securitisation Regulation's net being cast very wide, capturing financial arrangements for which the Securitisation Regulation regime was never designed in the first place and sometimes bringing in-scope transactions which the market does not see as securitisation , which in practice gives rise to unintended consequences and compliance challenges.

The highly prescriptive nature of the Securitisation Regulation can also raise issues in practice because it does not always reflect the nature of the market players involved in establishing and managing financial arrangements caught by that regime. From a CLO and wider European financial market perspective, for example, the industry had to adjust and to find new solutions as a result of the recast "sponsor" definition in the Securitisation Regulation, which lacked clarity (compared to the pre-2019 position before the Securitisation Regulation became applicable) as to whether a non-EU authorised investment firm, or a firm which would not otherwise need the requisite EU/UK investment firm status for the purposes of its activities, can qualify as a "sponsor". Despite the industry's multiple requests since 2018 for clarification of the position, to date no such clarification has been received, although it is possible that the wider Securitisation Regulation reforms on which the European Commission is expected to consult in October 2024 will finally address this point.

Therefore, any FSB recommendations in the final report for a more holistic approach to securitisation reforms will be gratefully received by the industry in acknowledgment of the fact that the securitisation market is a very diverse universe of financial products and a highly prescriptive approach to regulation or "one size fits all" approach (in particular in respect of non-prudential reforms like the Securitisation Regulation) can be both a force for good as well as a force that can cause unnecessary market disruption, driving up the costs and burden of doing a securitisation without sometimes any clear benefit to supervisors or the parties involved in the transaction, therefore hindering the growth of securitisation markets which could otherwise help to fund the real economy.

9. **Resilience metrics for the non-agency RMBS market: Does the report accurately describe the evolution of resilience indicators for the RMBS market? To what extent can the evolution of these indicators be attributed to the reforms?**

10. **Risk retention in RMBS: Does the report accurately describe risk retention practices in the RMBS market before and after the reforms? What additional analyses could be included to assess the effectiveness of risk retention in RMBS across FSB jurisdictions?**

11. **Effectiveness of BCBS securitisation reforms: Does the report accurately describe the changes in bank behaviour following the implementation of the BCBS securitisation framework reforms? To what extent can the effects of these reforms be disentangled from the broader Basel III framework, other reforms and confounding factors?**

12. **Simple, transparent and comparable (STC) securitisations: Does the report accurately describe the impact of the introduction of the STC framework on the securitisation market? To what extent has the reform met its objectives?**

13. **Effects on financing the economy: Does the report accurately describe the main effects of the reforms on financing the economy? Is there additional analysis that could be undertaken to estimate the benefits and costs of these reforms and to assess their impact on securitisation as a financing tool?**

14. **Effects on financial system structure and resilience: Does the report accurately describe the extent to which there has been a redistribution of risk from the banking to the non-bank financial intermediation sector? What role did the reforms play in this process and what are the main benefits and risks from a system-wide perspective? How have the reforms impacted the demand and supply of liquidity in securitisation markets?**

15. **Other issues: Are there any other issues or relevant factors that should be considered as part of the evaluation?**