CLIFFORD CHANCE

Briefing note

March 2014

Elephant spotting – Risk Retention under the CRR

In this briefing 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 once they have been considered by the EU Parliament and the Counsel (who have one month from that date to exercise their right of objection) as well as the implementing technical standards (ITS) published by the European Banking Authority (EBA) in December 2013. Please refer to our previous client briefing entitled "*New EU securitisation risk retention rules – redrawing the roadmap*" for an overview of the new EU regulatory capital regime, including its application to CMBS and CLO transactions.

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 briefing*); 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 briefing*).

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 briefing 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 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 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 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:

1. that the real exposure, upon which the notes are dependent, is to the corporate debt of the borrowing group;
2. 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;
3. (as is often the case on portfolio acquisitions) that the transaction cannot in substance be regarded as having an "originator", "original lender" or "sponsor" for the purposes contemplated in the CRR; and
4. (as is often the case on portfolio acquisitions) 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 a 5% reduction in debt raised.

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 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 client briefing 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 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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