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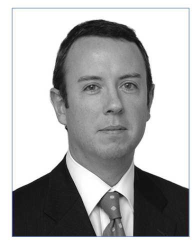

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Article 122a of the EU Capital Requirements Directive, as interpreted by the Council of European Banking Supervisors (CEBS), does not work particularly well for collateralized loan obligations, which represent roughly 60 percent of the source of funds for leveraged loans.

How it is implemented by local regulators will be a critical factor in determining whether and in what manner CLOs will be issued in the future. A number of issues will have to be overcome to allow the CLO market to operate efficiently within the restrictions imposed by Article 122a.

Background

Article 122a was adopted by the EU Parliament in 2009 as a response to the fallout of the financial crises and it became effective Jan. 1. It applies to all "credit institutions" in the EU that invest in "securitisations", a very broadly defined term that captures CLOs. Credit institutions that do not comply with Article 122a can incur punitive capital charges. CLO market participants who wish to access a European investor base, even if they are not European themselves, will need to structure their CLOs in a manner that complies with Article 122a. In addition to having a significant effect on the European CLO and leveraged loan market, Article 122a affects the US CLO and leveraged-loan market, which has historically relied on Europe for a large part of its investor base. Some issues facing CLOs include:

Who may retain risk?

Article 122a requires "originators" or "sponsors" to retain a material net economic interest of not less than 5% of the securitized exposures on an unhedged basis. The problem is that the parties who are involved in managed CLOs, and their roles, do not fit into Article 122a's definition of originator or sponsor. A sponsor must be a credit institution, which most CLO managers, other than bank CLO managers, are not. The definition of originator does not work well for CLOs because the underlying assets consist of syndicated loans acquired by the CLO in the secondary market that are not generally originated by anyone involved in the CLO. CEBS has issued guidance that an intermediate "originator special purpose vehicle" may be used to address the definitional issue. CEBS, which is now the European Banking Authority, envisages that loans would be acquired in the secondary market by an "originator SPV" and then sold on to the CLO (which is also a SPV). Unfortunately, while Article 122a was supposed to simplify transactions it has arguably done the opposite for CLOs by introducing the "originator SPV" alternative for the sole purpose of shoe-horning CLOs into the rules.

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In what form may, and for how long must, risk be retained?

While Article 122a offers four possible ways to retain risk, the one most suitable for CLOs is retention of the first lost tranche. Currently many CLO market participants assert that the entire first loss tranche must be retained, even if it represents more than 5% of the securitized risk. So, for example, if a CLO was structured in a way that the most junior tranche represented 15% of the loan portfolio, the person who agrees to retain risk for purposes of Article 122a would have to retain 15% rather than 5%. The person who initially retains the risk may not transfer it to third parties. This effectively renders the first-loss tranche illiquid and locks the retained risk holder into the CLO until maturity. Because such investors cannot liquidate their position, they will probably demand more say in the management of the portfolio. Market participants will have to balance the requirements of these first-loss investors with those of the rating agencies and holders of more senior tranches.

Who is eligible to fund the retained risk?

How will the originator SPV fund its acquisition of the retained risk? CEBS has stated that (1) such a funding party must be involved in the selection of the assets being transferred into the CLO and (2) CLO managers may not fund the acquisition of the first loss tranche with cash or other consideration provided by other investment funds for which the CLO manager is also an investment adviser. Like other investment advisers of hedge funds and private-equity funds, CLO managers are generally not principal investors—they manage other people's money for fees and carried interest.

Therefore, prohibiting funds managed by CLO managers from investing in the retained risk of a CLO severely limits the universe of potential holders of the retained risk. Because Article 122a seems to have been drafted with traditional securitizations in mind, on its face its application to CLOs is problematic.

Unfortunately, the CEBS guidance has, perhaps predictably, given some of the peculiarities of the CLO model, highlighted a number of other issues which will be of concern to the majority of CLO managers. Dialogue with the regulators must continue, and those concerns addressed as swiftly as possible, if the CLO industry is to take comfort that CLOs can sit sensibly within the restrictions imposed by Article 122a. If not, there is a chance that CLOs of the future will be fewer in number, more complex and require the involvement of new parties to the transaction.

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