

Feature

KEY POINTS

- The Alternative Investment Fund Managers Directive (AIFMD) introduces risk retention and due diligence requirements on AIFMs whose AIFs invest in securitisations.
- The definition of “securitisation” is very broad and may encompass a wide range of transactions.
- The AIFMD requirements appear to be more stringent than those under the Capital Requirements Directive.

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Risk retention requirements under the AIFMD: a difference in approach

EU alternative investment fund managers (AIFMs) investing in securitisation transactions (eg, CMBS or other tranching deals) will become subject to a 5% risk retention requirement, along with due diligence requirements, under the AIFMD. Given the breadth of the definition of “securitisation”, these requirements may apply in situations where AIFMs do not expect them to do so. This article examines the relevant requirements.

INTRODUCTION

EU member states are required to implement the EU Alternative Investment Fund Managers Directive (AIFMD) into national law by 22 July 2013. This article examines the 5% risk retention and related requirements imposed by Art 17 of the AIFMD and expanded upon in the “Level 2” Delegated Regulation relating to the AIFMD (the “Level 2 Regulation”). Given the breadth of the definition of “securitisation”, these requirements may apply in situations where alternative investment fund managers (AIFMs) do not expect them to do so.

The requirements discussed in this article apply only to AIFMs authorised under the AIFMD; that means, for the time being, EU AIFMs only. In late 2015 non-EU AIFMs may also start becoming authorised, while authorisation may be mandatory for non-EU

alternative investment funds (AIFs) managed by it to be exposed to any “securitisation” unless:

- the “originator, sponsor or original lender” retains a net economic interest of at least 5% in the securitisation (the “Risk Retention Requirement”);
- the AIFM ensures that the “sponsor and originator” grants credits based on sound credit granting standards (the “Credit Granting Standards Requirement”); and
- the AIFM has a “comprehensive and thorough understanding” of the securitisation positions and underlying assets before investing and, thereafter, monitors the securitisation on an ongoing basis (the “Due Diligence and Ongoing Monitoring Requirement”)

(together, the “Art 17 Requirements”).

The Level 2 Regulation provides that the Art 17 Requirements are to be interpreted in a consistent manner with the corresponding provisions of the CRD and the EBA Guidelines ...

AIFMs from end 2018.

It should be noted that the exact same requirements discussed in this article will also apply to UCITS managers (pursuant to the UCITS Directive) once the relevant Level 2 measures for the UCITS Directive are adopted.

THE ART 17 REQUIREMENTS

In essence, an AIFM that is authorised under the AIFMD must not cause

The Art 17 Requirements are set out in Art 17 of the AIFMD and are significantly expanded upon in the Level 2 Regulation.

The Art 17 Requirements are similar to the risk retention, due diligence and ongoing monitoring requirements that have applied to EU credit institutions (generally, banks) since 1 January 2011 as a result of an amendment to the EU Capital Requirements Directive (CRD) to introduce a new Art 122a (the

amendment being referred to as “CRD II”). The CRD has since been amended further (pursuant to “CRD IV”) such that the Art 122a requirements will, from 1 January 2014 (expected), apply also to EU investment firms.

Similar risk retention, due diligence and ongoing monitoring requirements will also apply to EU insurance and reinsurance undertakings when the Solvency II Directive is implemented (in theory, by 1 January 2014).

The Level 2 Regulation provides that the Art 17 Requirements are to be interpreted in a consistent manner with the corresponding provisions of the CRD (ie, Art 122a of the CRD) and the Guidelines issued by the Committee of European Banking Supervisors (CEBS) (which became, on 1 January 2011, the European Banking Authority) (the “CEBS Guidelines”) of 31 December 2010. However, as will be evident below, there is a significant divergence in one particular area, relating to the Credit Granting Standards Requirement.

GRANDFATHERING

The Art 17 Requirements apply to:

- “new securitisations” issued on or from 1 January 2011; and
- “existing securitisations” (that is, issued prior to 1 January 2011) from 31 December 2014 if there is a substitution or addition of assets.

Industry groups had expressed concern that the Art 17 Requirements could be interpreted as being retroactive. For example, if an AIFM had its AIF invest in October 2012 in a post-1 January 2011 securitisation (that is, prior to the AIFMD implementation date of 22 July 2013), and that securitisation did not contain a Risk Retention Requirement, would that AIFM be in breach of the Risk Retention

Requirement on 22 July 2013?

Given that the Level 2 Regulation provides that an AIFM/AIF “shall assume exposures” only if the Art 17 Requirements are met, it seems likely from a practical perspective that the requirements apply only to securitisation exposures assumed after 22 July 2013.

WHAT IS A “SECURITISATION”?

The AIFMD definition of “securitisation” cross-refers to that in the CRD and is very broad. “Securitisation” is defined in the CRD to mean “a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranching, having the following characteristics:

- payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and
- the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme”.

This means that any transaction that features a senior/subordinated structure is potentially a securitisation. The definition of “securitisation” goes far beyond what one might expect to be a “traditional” securitisation, such as a traditional residential or commercial mortgage-backed securitisation or an asset-backed commercial paper (ABCP) programme.

For example, if a credit hedge fund writes credit protection under a credit default swap (CDS) in favour of a bank in respect of a portfolio of loans, that CDS exposure may be a “securitisation position” where (as is often the case) the bank or some other party holds exposures above and/or below the “attachment point” for the CDS transaction. If so, the AIFM of that credit hedge fund would be subject to the Art 17 Requirements.

Similarly, if a private equity fund provides refinancing to a bank in respect of certain corporate loans, and the transaction features a senior/subordinated financing structure, that private equity fund’s financing exposure could constitute a “securitisation position” and thus subject the AIFM of that private equity fund to the Art 17 Requirements.

THE RISK RETENTION REQUIREMENT

Article 51 of the Level 2 Regulation provides that an AIFM shall “assume exposure” to a securitisation position for its AIFs only if the “originator, sponsor or original lender” retains, on an ongoing basis, a “material net economic interest” in the securitisation of at least 5%. This is, in essence, a “skin in the game” requirement.

The Level 2 Regulation prescribes five alternative methods by which the risk retention may be satisfied:

- retention of at least 5% of the nominal value of each of the tranches sold to investors;
- in a securitisation of revolving exposures (eg, credit card receivables), retention of at least 5% of the nominal value of the securitised exposures;
- in a transaction in which a pool of at least 100 exposures is potentially to be securitised, retention from that pool of exposures that have been randomly selected, equivalent to at least 5% of the nominal

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value of the securitised exposures;

- retention of the first loss tranche, so that the retention equates to at least 5% of the nominal value of the securitised exposures; or
- retention of a first loss exposure of at least 5% of every securitised exposure in the securitisation.

Whichever method is used, the prescribed net economic interest must be maintained on an ongoing basis. In addition, the retained interest must not be sold or hedged and must not be subject to any credit risk mitigation.

Commentary on the Risk Retention Requirement

One objective of Art 17 of the AIFMD, with Art 122a of the CRD, is to address a

“misalignment” perceived to arise in certain securitisation transactions as between the interests of originators and those of investors. However, the Risk Retention Requirement is not a requirement on the originator as such, but rather on the AIFM whose AIFs are exposed to the securitisation.

There is no requirement upon the originator actually to comply with its undertaking to retain the 5% exposure and there is no direct monitoring by the regulator of compliance by the originator (as opposed to by the AIFM).

The approach taken is therefore different to that in the US under the Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”). Like the AIFMD and the CRD, the Dodd-Frank Act includes a 5% risk retention requirement; however, the requirement there is for the *originator* to retain the risk, rather than for the *investor* not to invest unless the originator retains the risk.

One problem that may arise is where there is no clear “originator”, “sponsor” or “original lender” in the transaction. This could occur, for example, in a collateralised loan obligation (CLO) transaction, or another type of transaction where an entity simply holds a portfolio of assets (which it did not originate) and wishes to sell it on, but into a structure utilising senior/subordinated (tranching) financing. Note that “sponsor” is defined in the CRD to mean a credit institution (ie, bank), so a non-bank CLO manager could not be the “sponsor”. In this regard the CEBS Guidelines provide some assistance in that they note that the retention should then be satisfied by the entity whose interests are most aligned with those of the investors in the securitisation.

However, this is problematic in some transactions, including CLOs, where the CLO manager (assuming it is not part of a wider

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banking group) does not have the capital to support the 5% retention requirement.

Credit Granting Standards Requirement

Article 52 of the Level 2 Regulation provides that, prior to an AIFM assuming exposure to a securitisation on behalf of one or more AIFs, the AIFM shall ensure that the “sponsor and originator”:

- “grant credit based on sound and well-defined criteria” for credit-granting to loans, regardless of whether the loans are to be securitised or are to be held on balance sheet;
- have effective systems to manage and monitor their loans/exposures and make value adjustments and provisions;
- diversify their credit risk exposures;
- have a written policy on credit risk including risk tolerance limits and provisioning policy;
- grant “readily available access” to “all

It would mean, in effect, that the AIFM will need to demand to see the originator’s credit-granting policies for loans being securitised as well as loans being held on balance sheet.

materially relevant data” on the individual underlying exposures, cashflows and collateral;

- grant “readily available access” to all other relevant data necessary to enable the AIFM to comply with the Due Diligence and Ongoing Monitoring Requirement; and
- disclose to investors the level of their retention of net economic interest in the securitisation (as discussed above).

Commentary on the Credit Granting Requirement

The policy behind ensuring that originators and sponsors have consistent credit-granting standards is understandable, in that it is aimed at preventing originators and sponsors from applying more lax credit underwriting standards to assets that they are originating primarily to securitise, compared to those they hold on their balance sheets.

However, as a fundamental matter it is difficult to see how the AIFM can “ensure”

that the originator or sponsor has such processes and policies in place. It would mean, in effect, that the AIFM will need to demand to see the originator’s credit-granting policies for loans being securitised as well as loans being held on balance sheet. An originator may understandably have concerns as to confidentiality and the disclosure of commercially sensitive information to anyone who claims to be an investor in a transaction.

In addition, it is difficult to see how the Credit Granting Requirement could be satisfied where there is no clear “originator” or “sponsor” in the transaction (a situation discussed above in relation to the Risk Retention Requirement).

It would perhaps have been more practicable for the requirement to be that the AIFM is required to seek appropriate representations and warranties from the originator, rather than “ensure” the originator did so.

Most significantly, the Credit Granting Requirement is not imposed on bank investors under Art 122a of the CRD. Instead, the CRD-

equivalent to the Credit Granting Requirements is imposed on “sponsor and originator credit institutions” (ie, banks) under Art 122a(6) of the CRD. That is, under the CRD, bank investors are not required to “ensure” that the originator and sponsor have sound credit-granting standards; rather, an EU credit institution that is an originator or sponsor is itself required to have those standards.

In effect, when an AIFM is investing in a securitisation for which an EU bank is the originator or sponsor, the AIFM may be able to assume that the Credit Granting Requirement is met, since that EU bank originator/sponsor would already be required by Art 122a(6) of the CRD to have sound credit-granting standards in relation to any securitisation transaction.

However, where the originator/sponsor is *not* a bank, or where the originator/sponsor is outside the EU, the AIFM will need to comply with the Credit Granting Requirement under the AIFMD. This contrasts with a bank

investor under the CRD, which is not subject to such a requirement.

DUE DILIGENCE AND ONGOING MONITORING REQUIREMENT

Due diligence

Article 53 of the Level 2 Regulation provides that an AIFM must be able to demonstrate to regulators that, before its AIFs become exposed to a securitisation (and thereafter), it has “a comprehensive and thorough understanding” of the securitisation positions; and that it has implemented formal policies and procedures “appropriate to the risk profile of the relevant AIF’s investments in securitised positions” for analysing and recording such matters. The following are specified for this purpose:

- information disclosed to it as regards the Risk Retention Requirement;
- the risk characteristics of the securitisation position and underlying exposures;
- the reputation and loss experience in earlier securitisations of the originators or sponsors in the relevant exposure class;
- the statements and disclosures made by the originators or sponsors as to their due diligence on the securitised exposures and any supporting collateral;
- the methodologies and concepts on which the valuation of supporting collateral is based, and policies adopted to ensure the independence of the valuer; and
- the structural features of the securitisation (waterfall, credit enhancements, liquidity enhancements, etc).

This general due diligence requirement is expressed to be an ongoing obligation, although aspects of it are likely to be of greater relevance at the outset, rather than once the investment has been made. There are other specific requirements that are continuing obligations, as discussed below.

Separately, AIFMs must regularly perform stress tests appropriate to their securitisation positions, in accordance with the general stress test requirement in the AIFMD.

Ongoing monitoring

AIFMs must establish formal procedures commensurate with the risk profile of their

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investments in securitised positions to monitor on an ongoing basis performance information on the underlying exposures. The AIFMD prescribes the following as a non-exhaustive list of factors to be monitored:

- exposure type;
- percentage of loans more than 30/60/90 days past due;
- default rates;
- prepayment rates;
- loans in foreclosure;
- collateral type and occupancy;
- frequency distribution of credit scores;
- industry and geographical diversification; and
- frequency distribution of LTV ratios.

Where the underlying asset of the securitisation is itself a securitisation position (ie, it is a resecuritisation), the AIFM must obtain all relevant information in respect of both the underlying securitisation tranches and the assets underlying those securitisation tranches.

Commentary on due diligence and ongoing monitoring requirement

As noted above, AIFMs must regularly perform stress tests appropriate to their securitisation positions. Under Art 122a of the CRD, bank investors are permitted to rely on a credit rating agency's financial model (if the bank can demonstrate that it has conducted appropriate due diligence on the rating agency's own methodology and assumptions). Nothing in the AIFMD or Level 2 Regulation permits

an AIFM to rely on rating agencies in such a manner for its stress testing obligations, although one would not typically expect AIFMs to use rating agency models in the same way that banks might.

One clear effect of the due diligence requirements is that it may be difficult for an AIFM to have its AIFs invest in resecuritisations such as CDOs of ABS given that the underlying loan level data of the original ABS may not be forthcoming.

PENALTY FOR BREACH OF THE ART 17 REQUIREMENTS

The AIFMD provides that an AIFM is to take "such corrective action as is in the best interest

investment) or otherwise unwinding the contract (eg, in the case of a credit derivative).

In the Art 122a context, there is no requirement for a bank investor to dispose of the position (although penal risk weights would apply to the investment, resulting in a high capital charge for the bank).

However, the concept of "corrective action" is not in Art 122a, so it is difficult to say how the AIFMD requirement will be interpreted. Perhaps unhelpfully, there is no scope for the European Securities and Markets Authority (ESMA) to issue guidelines on what corrective actions may or should be taken by AIFMs in order to comply with the requirement.

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of the investors in the relevant AIF" where it finds that it has invested in a securitisation which does not meet the Art 17 Requirements. In particular, "corrective action" must be taken where the Risk Retention Requirement is not met on an ongoing basis (other than where the reduction below 5% is the result of the "natural payment mechanism" of the transaction).

Commentary on penalty for breach of the Art 17 requirements

It is unclear if "corrective action" means selling the position (eg, in the case of a bond

CONCLUSION

Notwithstanding the aim of regulators to set a consistent level of regulation on securitisation across the different sectors (banking, securities, asset management), it would appear that the aim has not been met in relation to the AIFMD as compared with the CRD (and potentially Solvency II). Fundamentally, however, it will be interesting to see what effect the differences in the approach will have on AIF investments in securitisations once the AIFMD is fully implemented. ■

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