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AIFMD:

CASTING A WIDER NET - RESTRICTIONS ON ABS & CLO INVESTMENTS ARE CATCHING UP WITH FUND MANAGERS

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The Institutional Investor's Advisory Group

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Executive Summary

AIFMD legislation will prohibit Fund Managers from assuming exposure to specific securitizations on behalf of their Alternative Investment Funds ("AIFs") where the "originator", "sponsor" or "original lender" does not retain a 5% net economic interest; in addition, it will impose extensive requirements on the investment selection process as well as the surveillance process for all securitization investments.

- The Alternative Investment Fund Managers Directives' ("AIFMD") will go into effect July 22, 2013.
- The restrictions and obligations relating to securitization exposure of Alternative Investment Funds ("AIF") apply to Alternative Investment Fund Managers ("AIFM") authorized under the AIFMD. For the most part, AIFs are any type of funds other than UCITS funds such as Irish QIFs, Luxembourg SIFs or German Spezialfonds.
- The definition of securitization is very broad and applies to any transactions that can be considered a tranched credit risk exposure, and may extend beyond structures commonly known as ABS or CLOs, such as certain derivative contracts or bank lending arrangements.
- The risk retention rule (also known as the "Skin-in-the-Game" rule) is consistent with CRD Article 122a and any applicable regulatory guidance: it requires "originators", "sponsors" or "original lenders" to retain a 5% economic interest in a transaction if they want it to be an eligible investment for an AIFM's AIF. The European Banking Authority ("EBA") is currently considering to have CLO collateral managers declared as "sponsors" in order to remove any ambiguity of the rule's applicability.
- The rule applies to all securitizations issued after January 2011 and also encompasses those issued prior to said date where collateral substitutions are to occur after December 2014.
- The extensive standards set for an AIFM's securitization investment selection process and ongoing surveillance process will indirectly affect anyone responsible for overseeing and monitoring the AIFM, such as fund directors or the custodian/depository.
- It is noteworthy that the *Dodd-Frank Act*, which passed in the U.S. in 2010, includes very similar risk retention provisions. Furthermore, risk retention rules will also be included in the upcoming revisions for the UCITS and Solvency II Directives so that the vast majority of European institutional investors will eventually be in scope.

Introduction

AIFMD mandates EU Member States to pass new laws designed to regulate AIFMs that manage AIFs by July 22, 2013. Managing investments for third parties will be a regulated activity in all EU Member States, regardless of the investors, the assets, or - apart from a few exceptions - the structures that are involved.

Investment management firms are considered an AIFM if they manage any type of investment fund other than a UCITS fund. UCITS funds are the European version of mutual funds that are eligible for public distribution to retail investors and are governed by laws following the various UCITS directives.

While the AIFMD subjects AIFMs to rules similar in nature to those known to firms managing UCITS funds, such as the need for minimum capital or an adequate risk management policy, it also imposes specific investment restrictions on certain types of asset classes such as securitizations. Previously, many of these restrictions applied only to banks.

The "Skin-in-the-Game" Rule

Since January 2011, European banks investing in securitizations have to adhere to risk retention, due diligence, and ongoing monitoring requirements - as defined in Article 122a of the EU Capital Requirements Directive ("CRD")

This risk retention rule, also known simply as "Skin-in-the-Game" rule, mandates that the "originator", "sponsor" or "original lender" retains, on an ongoing basis, a "material net economic interest" of at least 5% in those securitizations that have been issued after January 2011 or those which were issued prior to this date but where collateral substitutions are to occur after December 2014.

Further to the above, the Dodd-Frank Act (passed in the U.S. in 2010) includes very similar risk retention provisions. However, given the longer implementation process of Dodd-Frank, these rules are not expected to be practically applicable until late 2014 at the earliest.

AIFMD & Securitizations

The AIFMD definition of what constitutes a "securitization" directly refers to the definition provided by the CRD. While this definition is fairly broad, it does capture structures commonly understood as securitizations (i.e. RMBS, CMBS or CLOs) and at the same time creates ambiguity around certain other derivative and repo contracts which are not traditionally considered to be securitizations

In general, Article 17 of the AIFMD applies the same principles to AIF Managers that the CRD does to European banks. In an attempt to minimize the gap between the banking and asset management rules, the so-called Level 2 Regulation (which are more detailed guidelines issued by the European Commission to supplement the AIFMD) explicitly ties the interpretation of Article 17 to the corresponding provisions of the CRD (Article 122a) and the Guidelines of the EBA.

As it turns out, however, the rules imposed by the AIFMD relating to investments in securitization are going to be more onerous on asset managers than the rules set forth in the CRD or the Dodd-Frank Act that apply to banks as investors. In the context of an AIF, the fund's asset manager is deemed to be the investor, and the onus of complying is not placed directly on the parties involved in creating the securitization such as the sponsor, originator, or underwriter - as is the case with the Dodd-Frank Act.

The AIFMD prohibits AIFM's from investing in tranches of securitizations if the originator, sponsor, or original lender does not retain a 5% net economic interest in the transaction on an ongoing basis. In addition, the AIFM also needs to ensure that the sponsor's and originator's credit underwriting standards are of adequate quality and that the underwriting standards for loans originated for distribution or securitization are not lower than for those loans originated by bank's for their own book.

The CRD does not impose the same requirements on bank investors. Rather, similar to the Dodd-Frank Act's approach it requires such standards directly from the sponsor and originator banks.

Finally, the AIFMD explicitly prescribes extensive obligations for both an AIFM's investment process prior to the investment decision and for the surveillance effort while holding a securitization position. For bank investors governed by Article 122a, no comparable requirements

Questions of an Institutional Investor (NON-AIFM / NON-BANK)

Part I - Securitization assets held directly

AIFMD	Does AIFMD apply? No.
Liquidity	Will the secondary market deteoriate due to fewer potential investors?
Market Value	Will the market sell-off? Will quotes still be reliable for valuation purposes?
Remedies	Could there be remedies for existing deals to remain – and/or for affected deals to become - compliant with the new rules?
Held To Maturity	Am I comfortable with holding my investments through maturity if they become less marketable or would I potentially become directly subject to similar rules in the forseeable future (e.g. Solvency II)?
Duration	Will the rules change the credit and duration profile of existing securitizations and would certain pre-2011 CLOs have to become static after 2014?
Investment Opportunity	Could there be an investment opportunity triggered by an AIFMD induced sell-off and how could I take advantage of it?

exist. They may even continue to rely, to a certain degree, on the assessment performed by a rating agency in its credit rating process. While these due diligence and monitoring requirements are understandable (within the context of the mandatory UCITS-type risk management policies now adopted by AIFMD), the direct regulation of an AIFM's investment process that singles out a certain asset class is unprecedented.

Who will be Affected?

The restrictive regulation of an institutional investors' securitization exposure will have direct and indirect implications for almost everyone involved in the value chain of - a transaction. This include on one hand the various parties involved in creating and servicing a securitization transaction and on the other hand the investment funds and their service providers; both are middle links in the credit intermediation process connecting borrowers and the fund investors as the ultimate lenders.

Borrowers & Investors

Being positioned at the fringes of the credit intermediation process, borrowers and fund investors are not targeted by the AIFMD in their respective roles and thus are not subject to any new regulatory obligations per se. Nevertheless, they will certainly feel both the short and long term effects of the structural changes that are likely to follow the new rules.

The immediate concern of an existing securitization investor, and not just a fund investor, is how his current investments will be affected in regards to liquidity, market value, and even credit profile - with the potential that some of these investments could become ineligible either for himself or for other market participants.

Nonetheless, investors may benefit in that the new rules will increase the quality of securitizations and reduce the credit risks which are otherwise inherent in a transaction. However, at the same time, they may also have to bear increased management and governance costs stemming from the fund manager and service providers. By improving the confidence in securitization markets through an adequate alignment of interest and through the restriction of the participation of low quality firms, borrowers may benefit from a less volatile and thus cheaper financing market. Unfortunately, this could also have the unintended consequence, that some borrowers could face an increase in the cost of credit or even a reduction in the availability of credit altogether.

Originators & Sponsors

In a traditional ABS transaction, such as a residential mortgage backed security ("RMBS"), firms involved in the creation and ongoing servicing of the RMBS would firstly be a company that had originated the loans (i.e. the "originator" or "original lender") and secondly another company, or even possibly the same company, that would build the securitization's structure and underwrite and distribute its liabilities to the market (i.e. the "sponsor"). In addition, also involved may be a custodian bank, a trustee, a loan servicer and, in the case of CLOs and similar structures, a collateral manager as well as a collateral administrator.

The spirit of the new regulation seems to be primarily aimed at those parties involved from the beginning and in the creation of a securitization, and less so at those who are engaged as service providers on an ongoing basis.

Questions of an Institutional Investor (NON-AIFM / NON-BANK)

Part II - Securitization assets held indirectly through AIFs

AIFMD	Does AIFMD apply? Yes.
Breach Of Investment Restrictions	When will a breach be considered active or passive and what are the remedies (e.g. is the AIFM obliged to sell positions it had acquired prior to July 2013)?
Investment Manager	Is the investment manager aware of the new rules and will he be able to comply?
Other Fund Service Providers	Are the fund's management company, Master KAG, directors and custodian/depository aware of the new rules and will they be able to comply?
NAV	What will happen to my funds' NAV?
Costs	Will my administrative expenses rise due to higher management, oversight and governance cost?
Investment Opportunity	If there is a market opportunity, would the investment manager be in a position to take advantage of it?

The rules attempt to mitigate the risk of certain lenders underwriting loans negligently or even fraudulently with the intention of repackaging and selling them with no regard for their long-term performance. However, this would only apply to those cases where there is a close link between the party who makes the initial lending decision and the party that "securitizes"

In the schoolbook version of a securitization, a bank actively engaged in consumer lending would simply use securitization as an alternative refinancing technique; such a bank would be the "originator", "sponsor" and "original lender" all in one. However, in today's credit market the disintermediation of banks has progressed to such an extent that such a close link no longer exists.

The challenge of identifying the right" party to retain the 5% interest does not only exist for transactions that are traditionally not considered a securitization but would still fall under the AIFMD's broad definition, but is particularly pronounced for CLOs. CLOs clearly fall under the CRD's (and hence the AIFMD's) definition of securitization as it is "a transaction or scheme, whereby the credit risk associated with an exposure is tranched, having the following characteristics: (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme" (Directive 2006/48/EC, Article 4 (36)).

In the context of the same debate stemming out of the U.S., the Loan Syndication & Trading Association recently stated that there is no one entity involved in creating a CLO that originates assets on its balance sheet and sells or transfers them to the securitization. Instead, there is a collateral manager responsible for actively seeking out and sourcing loans both in the primary and secondary market, purchasing assets from a number of different banks and traders.

Whereas this "ramp up" process starts prior to the launch of a CLO using bank sponsored "warehouse" lines, it typically extends for a significant time into the life of the transaction during the "ramp-up" and "reinvestment" periods. It is noteworthy that this process is much more akin to the investment process of a fund manager than that of the lending and underwriting process of a bank.

Unfortunately, this dilemma cannot be solved logically and therefore the EBA is currently contemplating to declare CLO managers as "sponsors" by decree - ultimately this would become the applicable guideline for both CRD Article 122a and AIFMD Article 17. Needless to say, this would identify the CLO collateral manager as the party to retain the risk, although it is debatable if this special rule would really be in spirit of the law and it may cause other unintended consequences.

AIF Managers & their "Supervisors"

Investment management firms that meet the definition of AIFMs and who manage AIFs which invest into securitizations are clearly in the spotlight of the new rules.

Moreover, any party responsible for overseeing and ensuring that the AIFM is compliant with all of its regulatory and contractual obligations in relation to the funds' management will also be directly impacted. An example of such a party would be the board of directors to a fund, where this fund is organized as an investment company.

Questions of an Investment Manager

- Which of my client's assets fit the definition of securitizations?
- Can I clearly identify who is the originator, sponsor, or original lender in each of the securitizations held?
- Which of my current holdings will become ineligible assets starting in July 2013 and which may become ineligible starting in 2015?
- Would I breach investment restrictions even if I assumed the exposure prior to July 2013? If yes, what are the consequences?
- How does the market value, liquidity and credit profile of my positions change (based on the new rules)?
- How does my investable universe change? Could there be investment opportunities?
- Are my internal systems and procedures, my investment and surveillance process, and my checks and controls adequate enough to meet the new requirements?
- Are my funds' service providers aware of the new rules and are they able and willing to comply?
- Will my funds' expense ratios go up?
- Are my investors and clients aware of the new rules and how much do I need to educate them and/or keep them informed?

A funds' management company where it is not considered the AIFM itself and a funds' custodian and its depository will have oversight responsibilities over an AIFM's conduct and will hence also have to be familiar with the rules.

As for the "Skin-in-the-Game" rule, the AIFM will firstly have to assure that the risk-retaining party in a transaction would qualify as the "right" party, and secondly, that the legal documentation would contain representations and warranties in order to create sufficient comfort around the risk retention's structure and that of its ongoing nature. As aforementioned, the actual provision of sufficient risk capital in a structure which meets the AIFMD's and CRD's requirement would then fall upon the originator, sponsor, or original lender.

The requirements imposed on an AIFM's investment and surveillance process, which not only sets standards on how to analyze a securitization's structure and its assets but also extends to the evaluation of the sponsor and originator's credit underwriting process, could potentially be the bigger challenge both for the AIFM and those in charge of its oversight.

Assuming that regulators will not likely accept a "check-the-box" approach, some investment management firms will have to invest in additional IT systems and qualified personnel in order to be able to effectively perform a full "look-through" analysis of a securitization structure. This "look-through" analysis will practically require the transparent modelling and re-engineering of a transaction before an investment decision is taken. Furthermore, the model will have to be kept updated with the underlying collateral data on a regular basis in order to satisfy the ongoing monitoring and surveillance requirements. Standard software is available that would meet these requirements.

However, it would not typically cover more complex types of securitizations such as ABS CDOs. Management companies, board of directors, and custodians will also need to demonstrate that they have sufficiently qualified staff and adequate systems and infrastructure in place to properly be able to assess if an AIF and its manager are AIFMD compliant. For firms other than those few that are specialized in securitizations and structured credit products, this may be a high hurdle to overcome.

Grandfathering

There is some uncertainty if the risk retention rule only applies to new purchases after July 22, 2013, or if any securitization held from that day onward will automatically have to comply. The latter scenario, however, may not have been intended and would clearly be impractical to enforce. Rather, the wording in the Level 2 Regulation: "shall assume exposures" seems to imply the former scenario.

The AIFMD provides that a breach of the investment restrictions relating to securitization exposure must be remedied in a way that is considered in the best interest to the investor. This does not necessarily mean that the position needs to be immediately sold or unwound. In practise it will fall on the AIFM and its directors to make an appropriate judgment of what constitutes the investors' best interest in any given case. This judgment will likely be influenced by guidance provided by national regulators

Questions of a CLO Manager

- Will I be considered an AIFM and which CLOs and other mandates that I manage will fit the definition of securitization?
- Will I be considered the "sponsor" of the CLOs I manage?
- Will the CLOs that I issued after January 2011 and comply with 122a by using a third party, such as a controlling subordinate noteholder, become non-compliant if the EBA declares all CLO managers as sponsors?
- How many of my investors will be subject to AIFMD in addition to those that are already subject to CRD?
- Which of my CLOs will be become ineligible investments for my investors and will they try to sell those positions?
- For CLOs issued before 2011, will I be able to reinvest (including on a credit impaired/improved basis) if I want to protect my current and potential future investors?
- What effect will this have on future CLO issuances and the underlying loan markets?
- Is my credit underwriting process including my system and reporting sufficiently transparent to meet the due diligence standards of AIFMs?
- What is my communication strategy to investors?

regarding any ambiguous This judgment will likely be influenced by guidance provided by national regulators regarding any ambiguous questions; certain jurisdiction might prefer swift sales over attempts to retroactively heal a breach by restructuring a transaction.

Conclusion

The AIFMD's comprehensive rules for AIFM's securitization exposure is the EU policy maker's second strike in their attempt to regulate the global ABS market. Their approach, first implemented through the CRD, to impose restrictions on banks as investors in securitizations (i.e. the "buy-side") as opposed to "securitizers" (the "sell-side") has certainly proved to be impactful. After AIFMs having been caught in the wider net, European insurance companies, pension funds, and investment managers of European retail mutual funds will be next in line through the upcoming Solvency II and UCITS Directives. Market participants will have no choice but to adapt to the new rules .

Questions of a Director

- Which assets held on July 22, 2013 fit the definition of a securitization and would consequently become subject to the AIFM's new investment restrictions?
- Will I have to assess all the portfolios I oversee to this extent? If yes, will I be able to do so and be ready in time?
- Do I have adequate systems and controls in place to comply with the new rules, particularly in regards to new purchases?
- How many of my duties in respect to securitizations can I delegate to a third party?
- If there are passive and active breaches, what are the remedy options?
- Is the AIFM aware of the new rules and is he in a position to comply and/or has he taken appropriate measures to assure his compliance ? How do I need to document this?
- Are investors sufficiently aware of the new rules and have they been informed by the AIFM? What guidance can I receive from the funds' auditors and the local regulator regarding best practices?
- Is my pricing still adequate considering the increased effort required to cover this asset class?

Answers from Behring, Khan & Co.

The Principals of Behring, Khan & Co. have extensive investment management and structuring experience in the securitizations market, as well as with the management, governance and oversight of European regulated fund vehicles. They are uniquely positioned to answer many of the pressing questions and provide practical solutions to investors, directors and managers alike.

Behring, Khan & Co. can:

- Assist with assessing investment risks for Investors as well as with the regulatory and operational risks caused by the non-compliance of their funds' AIFM and service providers
- Support an AIF Manager by (1) reviewing their infrastructure and procedure in order to assure compliance with the new rules and by (2) advising on how to adjust their infrastructure and provide additional capacity to analyse an AIFM's investment process
- Assist boards of directors, management companiesand custodians in establishing adequate controls and procedures in order to assure compliance with the new directive

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