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The JC Report on the Functioning of the European Securitisation Regulation: An Unhelpful Regulatory Intervention for Europe's CLO and Securitisation Markets

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On 31 March 2025 the Joint Committee (the "**JC**") of the European Supervisory Authorities (the "**ESAs**") released a report (the "**JC Report**") on the functioning of the European Securitisation Regulation (Regulation (EU) 2017/2402) (the "**EUSR**"). The JC Report includes, among other things, an assessment of whether the EUSR has achieved its original policy objectives since implementation in 2019 and legislative recommendations to the European Commission (the "**Commission**").

In this Client Alert we focus on statements made in the JC Report regarding whether CLO originator vehicles (including collateral management vehicles) ("**CLO Originators**") satisfy the "not a sole purpose originator" requirement[1] for the purposes of determining eligible retention retainers under the EUSR, and the wider ramifications of those statements for the CLO and structured credit markets. In doing so, we identify several unintended and problematic consequences for such markets arising from the JC Report's guidance on CLO Originators.[2]

The JC Report is available here.

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1 Article 6(1), EUSR.

2 See the section of the Client Alert entitled "*JC Report – Wider Market Impacts and Unintended Consequences*"

Executive Summary

- The JC Report states that the term "predominant"[3], which is used in the risk retention regulatory technical standards (Regulation (EU) 2023/2175 (the "**RTS**")) in respect of the sole purpose test for originator retainers, should be understood to mean that an originator's revenues "*should correspond to no more than 50% on the exposures to be securitised, risk retained assets or proposed to be retained in accordance with Article 6 of the [EUSR], or any corresponding income from such exposures and risk retained assets*".[4]
- The JC Report's guidance, on its face, would appear to apply to all CLO Originators that are third party funded, regardless of whether such CLO Originators operate material other businesses (including a CLO management business). See, however, the discussion of the distinguishing features of CLO manager originators and, in particular, collateral management vehicles, later in this Client Alert.
- Transactions that priced or closed prior to publication of the JC Report (31 March 2025) are grandfathered and Milbank's view is that grandfathering should extend to secondary trading in such transactions.
- We expect the JC Report's guidance to have a material impact on retention structuring in the CLO and wider structured credit markets, and that such guidance may result in unexpected compliance actions by market participants with respect to risk retention (which are, in our view, illogical in the context of the policy aim of alignment of interest between the retention holder and investors). In addition, the JC Report's guidance increases barriers to entry in the European securitisation markets, which may reduce securitisation issuance and reduce investment opportunities for European investors. We discuss certain of these problematic impacts, focusing in particular on CLO transactions, in the section of this Client Alert entitled "*JC Report –Market Impacts and Unintended Consequences*".

Background

The JC Report includes, at Section 9, statements relating to the EUSR's risk retention rules. Of particular focus to the CLO market are the JC statements regarding whether certain types of CLO Originators[5], principally third party funded originators, comply with the "sole purpose originator" test under the EUSR.

The "sole purpose originator" test provides that originators shall not be considered eligible retainers where they are established or operate for the sole purpose of securitising exposures. Regulation (EU) 2023/2175 (the "**RTS**") provides further guidance on the sole purpose test and a safe harbour which states that so long as, *inter alia*, the retainer *"does not **rely on the exposures to be securitised, on any interests retained** or proposed to be retained in accordance with Article 6 of the EUSR, or on any corresponding income from such exposures and interests, as its **sole or predominant source of revenue**" (c.f. RTS, Article 2(7)(a)),* it will not be considered a sole purpose originator.

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[3] See related discussion under the heading "*Background*".

[4] Para 122, JC Report.

[5] The JC Report describes such originators vehicles as "*typically SPVs or similar structures… predominantly funded by third party investors who wish to gain exposure to a diversified pool of CLO risk retention notes. These entities first purchase the corporate loans on balance sheet before securitising these into the CLO. The vast majority of the SPV's revenues are derived from the risk retention notes".* Footnote 63, JC Report.

The accepted view of the CLO market had been that third party funded originators would satisfy the "sole purpose originator" test where they have significant "other business", such as a loan or CLO tranche trading business (typically ranging from 10-25% of its net asset value) or a collateral management business. However, the JC Report disagrees with such interpretation, with the JC advising, among other things, that "*3rd party origination CLO vehicle[s]… may not meet the objective of ensuring economic alignment between the sell-side and buy-side parties of a securitisation transaction given that the retention is funded by 3rd party investors*".[6]

JC Report - Sole Purpose Test Interpretation

The JC Report states that the term "predominant", used in the RTS in respect to the sole purpose test, should be understood as meaning that a CLO Originator shall not be considered as operating for the sole purpose of securitising exposures where its revenues "*correspond to no more than 50% on the exposures to be securitised, risk retained assets or proposed to be retained in accordance with Article 6 of the [EUSR], or any corresponding income from such exposures and risk retained assets*" (the "**>50% Other Revenue Test**")[7].

Further, the JC Report provides that "*going forward [i.e. from the date of the JC Report], any new issuance should apply this interpretation, which should also be used by the supervisors when assessing whether an entity has been established or operates for the sole purpose of securitising exposures*"[8].[9]

The JC Report's report would appear, on its face, to apply to all CLO Originators, notwithstanding that the "*sole or predominant source of revenue*" test in the RTS is a safe harbour for originator retainers (rather than an absolute condition to qualify as an originator retainer).

>50% Other Revenue Test

The JC Report (and the underlying EUSR and RTS) provides limited guidance on the >50% Other Revenue Test. However, Milbank's view is that the calculation should be as follows:

- the numerator is aggregate revenues that do not relate to exposures to be securitised or the retention interest ("**Non-Retention Revenue**"); and
- the denominator is the gross revenue of the CLO Originator,

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[6] Para 121, JC Report, acknowledges that the term "predominant" in the RTS gives room for interpretation and suggests that the Commission explore "*a more precise definition of the term 'sole purpose'*".
[7] Para 122, JC Report.
[8] Para 123, JC Report.
[9] At the same time, para 124 of the JC Report invites the European Commission to confirm the above interpretation and, if needed, to consider legislative adjustments to clarify the "sole purpose" test in the level 1 text of the EUSR ("as part of the European Commission's upcoming review of the securitisation framework in the context of the Capital Markets Union").

and, for the purposes of the numerator in the above calculation, Non-Retention Revenue shall include (a) income on "excess" subordinated notes beyond any retention interest[10], (b) income on "excess" senior and mezzanine notes beyond any retention interest[11], (c) management fees and/or CLO management fee rebates, (d) income on investments in "third party" CLOs, and (e) income on "other" non-CLO investments (including income received from wholly-owned subsidiaries net of liabilities), in each case, calculated on a gross basis.

As the income received and receivable on CLO securities and other credit investments is a fluctuating concept which may be affected by changes in interest rates or, in the case of CLO equity securities, the performance of the relevant transaction, the calculation of the >50% Other Revenue Test will not be an exact science. It may therefore need to be considered on a *pro forma* or periodic basis with reasonable assumptions.

Further, Milbank's view is that originator vehicles (including CLO Originators) which are part of a larger consolidated group and which derive all or a majority of its capital from an asset manager group parent may calculate the >50% Other Revenue Test on the basis of the group's consolidated revenues. Whilst such guidance is not explicitly included in the JC Report, noting the focus of the JC Report on third party funded CLO Originators and the proposed expansion of sponsor focused retention (see related discussion below), we think the better view is that sponsor funded originator vehicles that fail the >50% Other Revenue Test on a single entity basis, but would pass on a group consolidated basis, should not be regarded as sole purpose originators.

Originators – Whether Collateral Management Vehicles are Impacted

We note that there is an argument, albeit unclear, that the JC Report is intended to only capture third party origination vehicles. At footnote 63, the JC Report describes third party origination vehicles as "*typically SPVs or similar structures… predominantly funded by third party investors who wish to gain exposure to a diversified pool of CLO risk retention notes. These entities first purchase the corporate loans on balance sheet before securitising these into the CLO. The vast majority of the SPV's revenues are derived from the risk retention notes*".

The description of such third party originator vehicles and the "issue" which the JC Report addresses, appears to focus, more specifically, on third party CLO Originator retention funds rather than *bona fide* collateral management operating businesses earning fees for managing CLO transactions. This approach would be consistent with the CLO market's general view that third party originators are more susceptible to characterisation as "sole purpose originators" (due

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[10] Importantly, a retainer holding horizontal retention is required to hold proportionately less retention as the transaction amortises (because the 5% retention requirement is calculated by reference to the nominal value of securitised exposures). Accordingly, as the transaction amortises, a larger portion of the first loss holding will constitute "excess equity" for the purposes of the test's numerator.

[11] With respect to the inclusion of "excess" CLO investment beyond the retention investment in the numerator, we note that Article 2(7) of the RTS makes clear that, in complying with the sole purpose test, an originator can have regard to sources of income **other than** income that relies "*on the exposures to be securitised, on any interests retained or proposed to be retained in accordance with Article 6 of [the EUSR], or on any corresponding income from such exposures and interests, as its sole or predominant source of revenue".*

to a perceived absence of "other business").[12] However, the wider discussion in the JC Report on CLO Originators that utilise third party financing, which may include collateral management vehicles, cuts across this interpretation and fails to consider, for example, the regulated nature of collateral management vehicles (in and of themselves or acting in tandem with a regulated co-manager). See "*Limited Consideration to Regulated Manager-Originators*" below.

Grandfathering

The JC Report states that "*going forward [i.e. from the date of the JC Report], any new issuance should apply this interpretation*". Accordingly, where a CLO Originator fails to satisfy the >50% Other Revenue Test, existing CLO transactions are grandfathered for the purposes of compliance by such originator retainers with their obligation to retain in accordance with Article 6 of the EUSR and investors with their diligence obligations under Article 5 of the EUSR. We further consider such grandfathering to extend to secondary trading in such securitisation transactions, noting that the JC Report's clarification applies to "*new issuance*" from 31 March 2025 and no CLO investor involved in a secondary trade should be penalised if they have otherwise conducted appropriate due diligence on the basis of previously accepted market interpretations.

The JC Report is unclear on whether transactions that have priced, but not closed, and which have an originator retainer that does not satisfy the >50% Other Revenue Test, are grandfathered (as of 31 March 2025). However, since publication of the JC Report, the Association for Financial Markets in Europe (AFME) has communicated to its membership that the ESAs are supportive of a view that transactions that priced prior to publication of the JC Report, but that have not closed, should not be impacted by the publication of the JC Report. Milbank supports this view because the CLO Originator's commitment to retain in an affected transaction, and an investor's commitment to invest in such transaction, are determinations made at transaction pricing.

Pending further clarification, for instance in a new Commission proposal for amendment of the EUSR, new transactions (which we expect to include the reset and refinancing of existing transactions) will need to have regard to the >50% Other Revenue Test described above.

JC Report – Market Impacts and Unintended Consequences

The CLO market is digesting the impact of the JC Report's interpretation of the sole purpose test and the >50% Other Revenue Test, but Milbank's expectation is that it will have a material impact on retention structuring in the CLO and wider structured credit markets, and may result in unexpected behavioural changes by market participants with respect to risk retention compliance

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[12] The legitimacy of this view is supported by page 4 of the Financial Stability Board's Report "Evaluation of the Effects of the G20 Financial Regulatory Reforms on Securitisation" which includes the following when discussing third party financing of CLOs:

"*The financing, in some cases, of CLO managers' retained risk by third-party investors raises questions about the extent to which the objective of risk alignment is fulfilled, especially if the vehicle does not belong to the same corporate group as the CLO manager. Views on this issue tend to differ across stakeholders, with some arguing that third-party capital structures do not dilute the impact of risk retention while others note that they may do so in certain cases. More clarity on the conditions for such a practice to ensure risk alignment may be useful.*"

(which are, in our view, illogical in the context of the policy aim of alignment of interest between the retention holder and investors). Further, the JC Report's guidance raises additional barriers to entry in the European securitisation markets, which may reduce securitisation issuance and reduce investment opportunities for European investors. We have discussed below certain of these problematic impacts on the JC Report's sole purpose test guidance:

Unhelpful to Reviving the EU Securitisation Market: On its face, the JC sole purpose test interpretation runs contrary to ESMA's stated aim of "*reviving the securitisation market in the EU*"[13] and improving the functioning of the securitisation market to "*enhance the symbiotic relationship between bank and market based financing*".[14] CLOs provide vital liquidity to European corporates and represent a material portion of corporate financing in Europe.[15] The effect of the interpretation is to make it more difficult for CLO managers to originate CLO transactions (by curtailing risk retention financing sources), thereby potentially undermining CLO issuance in Europe and impacting liquidity (and financing costs) in the European leveraged loan market.

Does not consider the Unique Nature of CLOs: The 5% risk retention requirement for EU securitisations was introduced by European regulators to (x) address potential sub-standard credit assessments arising out of an originate-to-distribute business model by originating credit institutions; and (y) to create an alignment of interest between originators of assets and investors in securitisations.[16] Whilst we acknowledge and understand such objectives, the current EUSR retention requirements (and the JC Report's guidance with respect to the sole purpose test) fail to distinguish between balance sheet securitisations (e.g. with respect to receivables originated by credit institutions) and securitisations of assets acquired in the secondary market (e.g. CLOs).

CLOs are not disposed to the same "originate-to-distribute" considerations as balance sheet securitisations, and CLO manager-retainers have a natural alignment of interests with CLO investors as they earn management fees relating to transaction performance (and often acquire the first loss interest in the CLO transactions).[17] This has helped contribute to the strong performance of CLOs during and since the global financial crisis, with S&P noting that "*through 30 years and several recessions (including the pandemic-related downturn in 2020)… CLO ratings have shown only a modest number of defaults, and they have outperformed almost any other rated asset type*."[18] Further, CLOs represent an importance source of potential liquidity for

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[13] Recommendation 10, ESMA Position Paper, "Building More Effective and Attractive Capital Markets in the EU", May 2024, available at [Building more effective and attractive capital markets in the EU]
[14] Ibid, page 10.
[15] ESMA itself has acknowledged the benefits of CLOs for issuer and investors, noting that for issuers, "*leveraged loans allow corporates to diversify their funding sources beyond bank loans or bond issuance, thereby facilitating credit to the real economy*" and, for investors, "*CLOs can offer attractive returns, with low interest rate risk as those financial instruments are typically floating-rate*".
[16] Chapter 2, EBA report on securitisation risk retention, due diligence and disclosure (22 December 2014).
[17] Manager originators are subject to lighter requirements in the EUSR and related technical standards (for example, the risk retention RTS requires manager-originators to only "originate" 5% of securitised assets in order to qualify as the sole retainer in a European securitisation).
[18] https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/3147036

credit institutions and insurance companies, as demonstrated in the banking liquidity crisis in 2023.[19]

We further note that the US CLO market, which is five times the size of the European CLO market, no longer requires risk retention for "open market CLOs", in large part for the considerations discussed immediately above[20]. This factor has helped the CLO market flourish in the United States, providing important liquidity to US corporates. The JC and the Commission would therefore be wise to consider the impact of the new sole purpose test guidance on the European corporate borrowing market and whether a more refined approach to risk retention (if required at all) should be adopted for the European CLO market.

The >50% Other Revenue Test is Punitive to Certain Manager Originators: As drafted, the >50% Other Revenue Test is punitive to manager-originators that hold a 5% first loss interest in the transaction. In such circumstances (and particularly where the retained CLO(s) perform well), returns on the horizontal retention interest may (and in some cases are likely) to exceed management fees and other income. The same does not apply to manager-originators holding vertical retention holdings, where the retention revenues are likely to be lower reflecting the less risky nature of a vertical retention strip over a horizontal retention strip. It is of course illogical to distinguish between the two retention methodologies and penalise managers that agree to take the riskier first loss horizontal interest in the applicable CLO transactions. Arguably, horizontal retention creates more alignment of interest between the retention holder and the investors in the transaction, a point which adds further confusion on the rationale for the adoption of the >50% Other Revenue Test.

A >50% Other Revenue Test is Impractical: Related to the above, the >50% Other Revenue Test is unpredictable and therefore impractical. It is not possible for retainers holding horizontal retention interests to accurately predict expected returns over a medium to long term investment period. For such horizontal retainers, this will cause difficulties in assessing, on a forward-looking basis, the denominator in the >50% Other Revenue Test (and therefore ensuring compliance with the test). The practical compliance issues are less pronounced for vertical retention interests because, unlike horizontal retention interests, vertical interest returns are, for the most part, not profit linked. However, retainers holding vertical retention interests will still need to factor in potential spread increases and EURIBOR/SOFR rises when assessing compliance with the >50% Other Revenue Test (which is impractical and illogical).

Limited Consideration to Regulated Manager-Originators: The majority of manager-originator retainers in the CLO market are regulated entities, either as FCA regulated investment firms or SEC registered investment advisors or relying advisors. As a result, we would argue that such regulated manager-originators, by reason of their regulated status and *bona fide* CLO management business, are evidently not "sole purpose originators", regardless of whether they satisfy the >50% Other Revenue Test or are financed by third party capital. Unhelpfully, however,

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[19] By way of background, see the Basel Committee on Banking Supervision, The 2023 banking turmoil and liquidity risk: a progress report, dated October 2024 https://www.bis.org/bcbs/publ/d582.pdf
[20] *Loan Syndications & Trading Ass'n v SEC,* 2018 WL 798290 (D.C. Cir. Feb. 9, 2018)).

the JC Report applies the >50% Other Revenue Test to the assessment of the sole purpose test in respect of all originator entities and fails to distinguish between regulated manager-originator retainers and unregulated third party retainers.

The JC Report helpfully notes that the Commission should consider expanding the definition of "sponsor" to include third country regulated entities. However, it then goes on to warn against "empty shell" sponsor entities which, in our view, seems a misnomer where such sponsor entity is a regulated investment firm or investment advisor (or relying advisor on the same).

Impacts Legitimate Corporate Structuring: It is typical for sponsors of CLO management businesses to establish the business in a separate corporate entity, in part to facilitate ordinary M&A activity, for instance allowing the CLO collateral management business to be sold (where the retention cannot otherwise be transferred from the retainer as part of any business sale). The JC Report's guidance appears to restrict such practices, for the reasons discussed herein, which will make it more difficult for CLO businesses to be sold and consolidated in the future.

Limits Competition: If one reads the JC Report's guidance as meaning that CLO managers must form part of a wider corporate group, the natural consequence is to limit CLO management to the purview of the largest asset managers that have broader businesses. This raises barriers of entry to the CLO market and reduces competition in the market (potentially increasing management fees and reducing management incentives). It is also unnecessary for the reasons discussed above at "*Does not consider the Unique Nature of CLOs*".

Reduced CLO Investment Opportunities for European Investors: As a direct result of the JC Report's sole purpose test interpretation, our expectation is that US CLO managers may decide to not structure their US CLO transactions to be retention compliant (because, where a global retention fund invests in a retention compliant transaction, the revenue from such retention interest will be treated as "bad revenue" for the purposes of the >50% Other Revenue Test). Accordingly, European investors will have fewer opportunities to invest in US CLOs and European CLO investors will be more concentrated in European leveraged loans (potentially increasing systemic risk in the European economy).

Wider Impact on the European Structured Credit Markets: It cannot be assumed that ordinary balance sheet originator transactions will meet the >50% Other Revenue Test. For example, fintech, fund financing, aviation financing, auto financing vehicles and SME lending platforms are all potentially impacted by the JC Report's interpretation and will need to consider whether the relevant originator vehicle has substantive "other business" to meet the test, potentially curtailing the wider structured credit markets in Europe. Our belief is that this was not the intention of the JC and the Commission when formulating its sole purpose test and we hope and will lobby for clarification on this point as soon as possible.

Conclusion

As the JC acknowledges itself, the JC Report coincides with the Commission's examination of the legislative revision of the securitisation regulatory framework, including the EUSR, and wider European reforms prioritising securitisation in the 2024-2029 legislative term of the Commission.

The JC further states that the JC Report's intention is to unlock "*the potential of traditional securitisation markets while maintaining strong investor protection*". For the reasons discussed above, we consider the sole purpose test clarifications to run contrary to such intentions and to be fundamentally misguided in the context of the CLO market.

Milbank welcomes wider industry discussion on how the unique nature of CLOs, and their importance to the wider economy, should be accounted for in the context of the current risk retention framework. Further, in the short term, we encourage the ESAs to clarify that collateral management vehicles, notwithstanding potential third party funding sources, should not be considered "sole purpose originators" where they have a clear collateral management role in respect of the CLO for which they retain.

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