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ECON's draft amendments send positive signal to CLO market (9fin)

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Influential members of the European Parliament's Committee on Economic and Monetary Affairs (ECON) have tabled draft amendments to the EU's securitisation regulation (SECR), offering what sources describe as a constructive, though preliminary, signal for the CLO market.

The most significant aspect of the draft amendments for the CLO market concerns the long-running uncertainty around the sole purpose test for risk retention.

Over the past year, a series of commentaries and legislative amendments have sought to give the market greater clarity around what constitutes a "good" originator. Much of the debate has centred on how the sole or predominant purpose language should be interpreted in practice.

ECON members are now proposing three clarifications that directly address concerns raised, particularly following the JC report, while also indicating support of the JC report's proposal to broaden the 'sponsor' definition. The three clarifications are centred on adding safe harbour provisions, taking a case-by-case approach and providing relief to funds.

The proposals form part of the ongoing trilogue negotiations between the Parliament, Commission and Council. Alone, they do not change the law. But they mark an important point in a process that could materially reshape the regulatory environment for European securitisation.

“It’s a positive smoke signal,” said Chris McGarry, partner at Mayer Brown. “The proposals demonstrate that ECON members have clearly listened to some of the concerns expressed by the market, not just in the last year, but in the last decade. And very specifically, there are lots of helpful proposals in there for both the Euro CLO market and the US CLO market.”

At this stage, however, market participants stress that the drafts are directional rather than determinative and are only one stage in the legislative process.

John Goldfinch, a partner at Proskauer, concurs these draft proposals are positive signals for the CLO market, but emphasises there is no immediate legal impact and the proposals do not carry the same weight or have the same market influence as last year’s Joint Committee report. Rather, it is one contribution to a much broader legislative process that remains ongoing, but the direction of travel looks positive.

The next steps include refining the draft within ECON ahead of the European Parliament vote in May, establishing the Parliament’s formal negotiating position and engaging in trilogue negotiations with the Council, where some member states may adopt more conservative positions. These are expected to be finalised by the end of the year.

Three clarifications for CLOs

1.Safe harbour

First, ECON proposes that any formal guidance from the European Banking Authority (EBA) on the sole purpose test should be delivered by way of safe harbour only.

The concept of a safe harbour has become central to the market debate over the last year, even though the term itself does not appear in the legislation.

Goldfinch says an earlier draft of the sole harbour concept was effectively creating a tick-box list.

"If certain specified conditions were met, an entity would be deemed outside the sole purpose restriction. The appeal of a safe harbour is that it provides clarity and predictability, and all further clarifications to that list are welcome (whilst leaving open the possibility for structures to comply in other ways, as is suggested by the proposals). If you can tick clearly defined boxes, you can be comfortable that you fall within the rules. Without that, firms are left navigating grey areas."

This debate has been particularly acute in relation to the 50% revenue test. The level 1 text considers only a sole purpose test while the level 2 text refers to "sole or predominant" revenue. The JC report, in their commentary on third party retainers involved in CLO transactions, suggested that "predominant" should mean more than 50%, and framed this as a revenue-based test.

However, that 50% revenue threshold does not appear in the Level 1 legislation itself and the JC report was in the form of an Article 44 report as an input paper for the Commission rather than standalone guidance. The status of the JC report has caused some uncertainty as the Commission did not include any of the JC report's recommendations on risk retention when the Commission published its proposed amendments to the SECR last June.

Notably, the current ECON draft does not further advance or even reference the 50% revenue test. Instead, it points more broadly toward clarifying what conditions need to be satisfied. Logically, that could mean either formalising a revenue threshold in legislation or articulating the test in different language. Many expect that the final outcome is more likely to retain the existing level 2 wording rather than introduce a formal 50% rule, which, in itself, would remove some of the pressure created by last year's interpretation.

2.Case-by-case approach

Second, ECON proposes that where an entity does not fall within a safe harbour, compliance should be assessed case by case, based on the facts and the economic substance of the retainer, says McGarry.

Importantly, the case-by-case language recognises that there are many legitimate ways to structure an originator. A properly drafted safe harbour can provide a clear and comfortable route to compliance. But the draft does not seek to dictate a single, narrow model. Other structures may also qualify as good originators, provided they are assessed against the relevant principles.

Sources describe this combination as helpful and would restore a degree of certainty to the principles-based approach seen in the market prior to the JC report.

3.Comfort for funds managed by asset managers

The third clarification is potentially the most consequential for CLOs.

The draft provides that: *"Funds, acting as originator and retainer, established and managed by a sponsoring entity, such as asset managers or trustees, provided that such sponsoring entities can clearly demonstrate that securitising exposures is not a purpose, but a means to finance their business, shall be deemed to satisfy this sole purpose test."*

In practical terms, this signals that a fund with a regulated asset manager can act as risk retainer without being presumed to fail the sole purpose test.

This is particularly important in the CLO context with many managers working to structure retention funds that qualify as good originators without falling foul of the sole purpose test.

"The draft language suggests ECON recognises that such funds are investment vehicles, not originate-to-distribute fee machines and therefore not the type of entity the original G20 risk retention rules post-GFC were designed to curb," McGarry said.

"The original purpose of the risk retention rules was to stop sell-side parties making fees from encouraging weak underwriting and then transferring that risk to the market, not to prevent sophisticated investors from investing."

If preserved through trilogue, this clarification could resolve a decade of recurring uncertainty around how the sole purpose test applies in the CLO market.

Shift in policy tone

The ECON amendments sit within a broader policy pivot at EU level for their 2024 to 2029 agenda.

For much of the post-crisis period, securitisation, including CLOs, was viewed primarily through a conservative lens and as an area requiring strict oversight. That tone has shifted materially.

Under the EU's Savings and Investment Union agenda, securitisation has been identified as a core mechanism for mobilising capital and improving the functioning of European capital markets. The message from Brussels is increasingly clear that securitisation is part of the solution.

That shift is visible in several developments within the broader reform package, which aims to stimulate rather than constrain market activity.

As reported last year, Solvency II amendments would significantly improve capital treatment for certain securitisations, particularly CLOs and CMBS. Before the global financial crisis, European insurers allocated more than 10% of assets under management to securitisation. Today, that figure is below 1%, compared with roughly 12–13% in the US.

The proposed amendments would reduce capital charges by a fair amount. For EU insurers investing in CLOs, return on capital is expected to increase from around 8–9% to around 40%. That improvement could redirect significant insurance capital into the asset class.

Sources say the Commission has indicated that the full securitisation reform package is targeted to come into force together in January 2027.