



CLO Insights Series

# Risk Retention Deep Dive

April 2026

## Introduction

The idea behind Risk Retention (sometimes called “skin in the game”) is to improve standards in Asset Backed Securitisations (ABS) by aligning the interests of those who create ABS transactions with those who invest in them.

It is perhaps useful to think about skin in the game like an insurance excess. If you have to pay the first £500 of any damage to your car it changes the way you drive. You are “on risk” and therefore likely to be more careful.

The Risk Retention Rules were introduced in response to the Global Financial Crisis (“GFC”). The “Originate to Distribute” model was considered partly to blame for losses in sub-prime mortgage securitisations. There was a perceived conflict of interest as originators of the mortgages were viewed as not taking enough care to ensure the creditworthiness of the underlying borrowers as the risk was being passed on to others by means of securitisation.

This note discusses the “Risk Retention Rules” as applicable under the EU and UK securitisation regulations.

### So, what is securitisation?

A securitisation is a transaction whereby the credit risk of a portfolio of assets is divided up into different layers (tranches). Payments to different tranches are dependent upon the performance of the portfolio and paid according to an order of priority in the structure which determines the distribution of any losses (See Pemberton CLO Insights – The Waterfall).

Although CLOs survived the GFC relatively unscathed (see Pemberton CLO Insights – CLO Market) they were tarred with the same brush as sub-prime mortgage securitisations.

The definition of securitisations therefore captures CLOs and also CLO warehouses.



## So, what do the Risk Retention Rules say?

The Risk Retention Rules impose an obligation on CLO **Sponsors, Original Lenders or Originators** to hold on an ongoing basis a material net economic interest of not less than 5 % in a CLO (and a warehouse), referred to in this note as the "Retention Interest". EU or UK (as applicable) institutional investors are also required to verify that this risk retention requirement has been satisfied.

## So, who are all these people and what do they do?

**A Sponsor** is a credit institution or investment firm that establishes a CLO and purchases assets from third parties and subsequently manages the portfolio.

**An Original Lender** is the entity which, itself or through related entities, was involved in negotiating the underlying loan or bond with the borrower or issuer.

**An Originator** can be an original lender or an entity which purchases assets from third parties for its own account and then securitises them.

Please see below for more details about these parties but first we will look at what the term "Retention Interest" actually means.

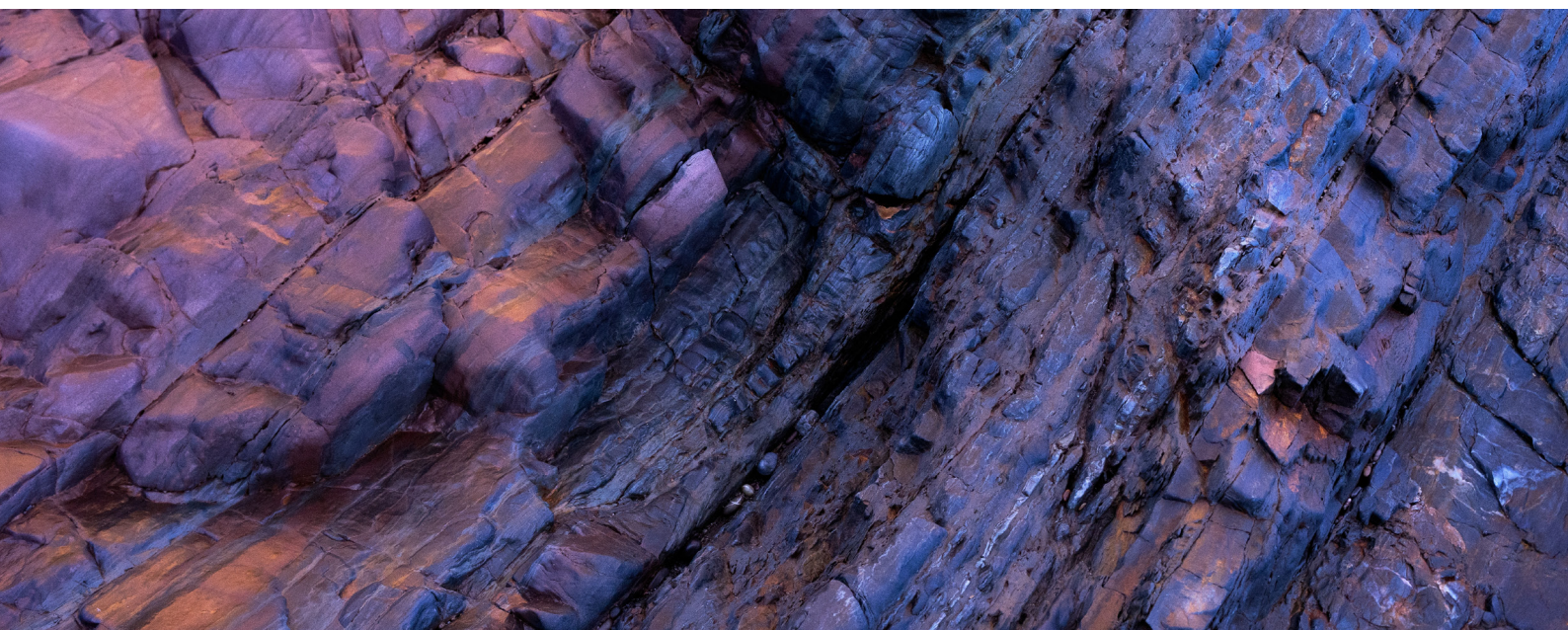
## Retention Interest

There are five ways that the Retention Interest can be held but only one method can be applied in any particular case.

1. Holding in the first loss tranche of not less than 5% of the nominal value of the securitised exposures (a 'horizontal' slice)
2. Not less than 5% of the nominal value of each of the tranches sold or transferred to the investors (a 'vertical' slice).
3. In the case of revolving securitisations or securitisations of revolving exposures, the retention of the originator's interest of not less than 5% of the nominal value of each of the securitised exposures.
4. The retention of randomly selected exposures equivalent to not less than 5% of the exposures in the portfolio provided there is at least 100 assets at origination.
5. The retention of a first loss exposure of not less than 5% of every asset in the portfolio.

The Risk Retention Holder must keep the holding for the life of the CLO. It is permissible to finance the Retention Interest provided this does not involve selling or hedging the associated credit risk. Retention financing techniques such as repos are more commonly used in connection with vertical retention holdings.

EU and UK institutional investors are obliged to verify that the Risk Retention Rules have been satisfied and carry out a due-diligence assessment to assess the risks involved in the CLO. Non-compliance may result in sanctions being imposed.



## Types of Risk Retention Holders

There are a number of established routes to funding the Retention Interest.

### Sponsor Route

In theory this is the simplest and easiest route.

The CLO Manager invests 5% (€20m for a €400m CLO).

However, this is not so straightforward as it seems.

- The CLO Manager needs to be a regulated investment firm under MiFID to qualify as a “sponsor” under the Risk Retention Rules.
- The amount of capital (i.e. investment in a horizontal slice of subordinated CLO notes and a first loss tranche of a warehouse) required to build a profitable CLO Platform of ca. €2bn is ca. €100m (see Pemberton CLO Insights – Building a CLO Platform).
- This route means that there is a barrier to entry giving large asset managers an advantage and depriving investors of choice.

### Co-Manager Route

If the CLO Manager does not have the capital itself, it can team up with a co-manager who can provide the funding. The co-manager would need to show that it is actively involved in some aspect of the management of the CLO perhaps by sitting on the investment committee and approving trades. This would clearly mean sharing the management fee. This method is seldom used.

### Original Lender Route

This is most likely to be a bank wishing to securitise some of its portfolio. It becomes the Risk Retention Holder by virtue of originating the assets. Such “balance sheet” CLOs need to clearly explain to Investors how the CLO will be managed independently from the bank’s own assets. So called “captive” CLOs experienced some of the worst outcomes in the CLOs issued before the GFC. These balance sheet CLOs are rare compared to the arbitrage focused CLOs that currently drive the market.

### Originator Route

There are two ways to qualify as an “Originator” for the purposes of the Risk Retention Rules. It is either an entity which:

- a. itself or through related entities, was involved in the original agreement which created the obligations being securitised; or
- b. buys assets for its own account and then securitises them.

The first option is very similar to the Original Lender route as discussed above. The second option can be satisfied in two main ways:

### 1. Manager Originator Route

This is where the CLO manager holds the risk retention investment as “originator” for the purposes of the Risk Retention Rules. The CLO manager may obtain third party funding (including by way of repo) in order to finance its holding of the Retention Interest.

Apart from taking and holding the Retention Interest in the CLO, there are a number of additional requirements that need to be satisfied in order to comply with the regulations:

- The Manager Originator must have substance and be regulated in its own jurisdiction. This involves setting up appropriate structures and policies and may impose capital and reporting obligations. Decisions are made by the board in the jurisdiction of the vehicle meaning a degree of travel for the CLO Manager.
- The Manager Originator must also originate (i.e. be on risk) for at least 5% of the assets that are subsequently included in the CLO.

One of the ways that have been used to fulfil the second condition is by the use of Conditional Sale Agreements. This is where the Manager Originator agrees to buy assets from the CLO if they become defaulted during a specified period of time (or “seasoning period”) prior to the CLO closing date (typically 15 business days). It has recently (August 2025) been clarified by the European Commission that this is not what was originally intended and CLOs that have used this technique have not complied with the Risk Retention Rules. Since this is a clarification of existing law, there has been no “Grandfathering” of these CLO transactions which are now being remediated by a number of CLO managers.

### 2. Third Party Originator Route

This is where a third party investor provides the funds and holds the Retention Interest, but the vehicle is independent from the CLO Manager. Instead, the CLO Manager often becomes the Investment Advisor to the vehicle.

This vehicle does not need to be a regulated credit institution or investment firm but will need to comply with customary corporate requirements (such as filing accounts and holding board meetings). The vehicle will also need to be compliant with the following requirements to ensure that it qualifies as an “originator” for regulatory purposes and is therefore eligible to hold the Retention Interest:

- The vehicle needs to be involved in the establishment of the CLO (e.g. by signing the engagement letter with the arranger and appointing service providers) and taking part in negotiation of the warehouse and the CLO documents.
- It must have a board including expert directors who are experienced and capable of assessing the credit risk of individual assets and managing the vehicle.
- It must not have been established for the sole purpose of securitising exposures or holding the Retention Interest. This means that it should have a broader business strategy and capacity to meet its payment obligations from other capital and sources of income. In other words, it must not rely on the securitised exposures or the Retention Interest (or any corresponding income) as its sole or predominant source of revenue. In March 2025, a Joint Committee of EU supervisors expressed its view that this means that an “originator” must derive more than 50% of its revenues from sources other than the exposures to be securitised or the risk-retention securities. Existing transactions that did not meet this requirement have been Grandfathered.
- In addition to having a general origination business which constitutes its predominant source of revenue

as mentioned above, it must also season (i.e. be on risk for) at least 50% of the assets that are subsequently securitised in the relevant warehouse and / or the CLO. For this purpose, Third Party Originators typically use Forward Sale Agreements, which provide for the sale of assets from the originator to the CLO on a forward basis provided they have not defaulted during the seasoning period. Since this involves the actual purchase and sale of assets by the originator, Forward Sale Agreements are, in general, not caught by the recent update regarding Conditional Sale Agreements referred to above.

## Conclusion

Risk Retention is an important requirement serving to align the interests of Investors and other parties in a CLO transaction.

Recent clarifications have been helpful in the interpretation of the regulations for the benefit of all parties in the CLO market.

*Produced in association with Weil, Gotshal & Manges (London) LLP.*



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