The Commission's EMIR proposal - impact on securitisation

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In May 2017 the European Commission published a legislative proposal to amend the European Market Infrastructure Regulation **(EMIR).** The proposal aims to reduce the compliance burden on smaller financial services firms, corporates and pension funds. However, the current form of the proposal would significantly increase the burden on securitisation issuers.

Under the proposal, securitisation special purpose entities **(SSPEs)** would no longer be classified as non-financial counterparties **(NFCs),** but be reclassified as financial counterparties **(FCs).** This would catch a wide range of transactions including some private asset-backed transactions as well as public securitisations, as the term 'SSPE' refers back to the broad definition of 'securitisation' in the EU Capital Requirements Regulation. Classifying securitisation issuers as FCs would directly subject them to the EMIR clearing obligations and margin requirements for all their non-cleared over-the-counter **(OTC)** derivative transactions.

This proposal has come as an unwelcome surprise to many in the market. Although in many cases the volume and nature of the derivatives entered into by an SSPE mean than it would not need to clear its trades, the SSPE would still be required to acquire and post margin under the non-cleared OTC margin rules. In particular, SSPEs with derivatives activity below the clearing threshold (which is EUR 3 billion for interest rate derivatives and foreign exchange derivatives) would be fall within the new "small financial counterparty" **(FC-)** regime proposed by the Commission and so would not be subject to the clearing obligation, but this would not exempt them from the non-cleared OTC margin requirements. These require daily posting of margin between both parties to a derivative transaction reflecting changes in its mark-to-market value.

In most cases SSPEs will not be in a position to post margin because, in order to maintain an efficient funding structure, there is typically no free cash or liquid assets left in the vehicle beyond specific, limited reserves. Likewise, the SSPE's cashflows are typically set up simply for hedging the mismatch between the receivables and obligations, not for the provision of collateral against market movements in the value of the hedging contracts. Considered from the position of a swap counterparty, there should be no need for SSPEs to be subject to additional clearing or margining requirements because typically in securitisations all of the assets of the SSPE are already pledged for the benefit of creditors, including swap counterparties, mitigating the counterparty risk on the SSPE.

Accordingly, if the Commission's proposal were introduced in its current form, securitisation structures might have to retain more cash to meet the collateral needs, introduce additional third-party liquidity, avoid hedging altogether or be restructured to minimize currency and interest rates mismatches. Each of these options may result in significant costs, an impact on ratings and a reallocation of risk. Moreover, an imposition of the margin requirement would also lead to additional operational concerns for SSPEs (such as valuations and reconciliation requirements) and these would need to be delegated as SSPEs do not have the resources to comply. Whether existing securitisations would be subject to this new treatment for SSPEs will depend on whether grandfathering is available: under the current proposal, it is not. In either case, it would seem likely that some transactions would cease to be economically viable.

The impact of the Commission’s proposal would be lower for certain transactions if it is implemented with or subsequent to the implementation of the proposed new EU Securitisation Regulation. The current draft Securitisation Regulation exempts transactions which qualify as “simple, transparent and standardised” (“**STS**”) securitisations from both the clearing and (to some extent) margin requirements under EMIR. However, some classes of securitisation, such as CLOs, would not fall within the STS and would not benefit from this exemption and it is not yet clear whether and how the STS regime will apply to UK securitisations following Brexit.

The Commission’s proposal would not affect asset-backed financing vehicles which for technical reasons fall outside the definition of an ‘SSPE’, for example repackaging vehicles that do not issue multiple tranches of debt. This may create a greater incentive for the use of such vehicles.

The SSPE proposal seems to be contrary both to the deregulatory tone of the remainder of the Commission’s proposals on EMIR and also to the stated purpose of the new Securitisation Regulation, which seeks to restart the securitisation market in Europe as an alternative funding mechanism. More broadly, the SSPE proposal would appear to undermine the Commission’s Capital Markets Union initiative. Given that the explanatory memorandum included in the proposal contained no discussion of the policy rationale behind the change it may simply be that the serious consequences of the change and the credit protections already built into most securitisations had not been fully appreciated before the Commission’s proposal was published. The Commission’s proposal is currently open for (public) feedback and while the Commission has stated that it will not be amended before being put before the European Parliament and the Council, it may be that the combination of industry reaction and other political pressures will result in the SSPE proposal being re-considered.

If you would like to discuss further, please do not hesitate to contact a member of our team.

Guy O’Keefe
T +44 (0)20 7090 3299
E guy.o’keefe@slaughterandmay.com

Richard Jones
T +44 (0)20 7090 4733
E richard.jones@slaughterandmay.com

Oliver Storey
T +44 (0)20 7090 3987
E oliver.storey@slaughterandmay.com

Oliver Wicker
T +44 (0)20 7090 3995
E oliver.wicker@slaughterandmay.com

Eric Phillips
T +44 (0)20 7090 3055
E eric.phillips@slaughterandmay.com