SLAUGHTER AND MAY

The EU Securitisation Regulation - where are we now?

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Key points

- The EU securitisation regime is in the process of being overhauled.
- The definition of securitisation is wide. Careful analysis is necessary to determine whether a given transaction falls within its scope.
- Amending legacy transactions can in some circumstances bring them within the new EU securitisation regime.
- The new transparency obligations are particularly complex and market understanding of them is evolving. Decisions over how to comply with them will often be highly transaction specific.
- There are open questions over how investors should due diligence securitisations, particularly those involving third countries.

Securitisations where new securities have been issued on or after 1 January 2019 are subject to the EU Securitisation Regulation, which, together with its related binding technical standards, guidelines, questions and answers and parallel changes to the Capital Requirements Regulation (the CRR), comprise the EU's new securitisation regime. Partly because there are inherent ambiguities within the Securitisation Regulation itself and partly because the majority of its implementing measures have still not been finalised, the securitisation regime continues to raise compliance challenges. In this briefing we consider some of the open questions as to the scope of the regime and how to comply with it. For a discussion of the STS regime, see our separate briefing.

The scope of the regime

1. Is my transaction caught by the regulatory definition of 'securitisation'?

The definition of 'securitisation' is a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics:

a) payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures;

b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;

c) the transaction or scheme does not create exposures which possess all of the characteristics [of a specialised lending transaction]

The definition of securitisation under the EU Securitisation Regulation is substantively similar to the old CRR definition, with one clarifying change (the specific carve-out of specialised lending transactions). The definition therefore remains very wide and potentially includes certain transactions which do not fall within the conventional market understanding of a 'securitisation'. However, under the new regime, the regulatory consequences of a transaction falling within the definition, both in terms of obligations on securitisers and investors and in terms of capital treatment are now more significant than ever. This has caused a renewed focus on how to apply the definition in practice. Because there is limited formal regulator guidance and (to our knowledge) no case-law on the definition, a body of market practice and belief has arisen in relation to its scope, based partly on informal discussions with regulators and partly on the collective understanding of the market as to the policy intent.

What does 'dependent' mean?

A transaction will not fall within limb (a) of the definition of 'securitisation' in circumstances in which, on an economic analysis, the credit risk being borne by investors is not principally related to the performance of the underlying exposures. This will often be a difference of degree rather than a difference in kind and therefore may involve a qualitative assessment and a consideration of the transaction as a whole.

The key characteristic in determining 'dependency' is a direct correlation between payments in respect of underlying exposures and payments to investors. Where transactions include a payment waterfall specifying the application of payments generated by one or more underlying exposures, or limited recourse provisions whereby the recourse of investors is restricted to such underlying exposures, this may indicate that payments under the transaction structure are dependent on the underlying exposures. The existence of an SPV borrower may also indicate a securitisation structure, because the SPV has fewer additional liabilities that would impact a structure intending to have dependency on the underlying exposures.

Conversely, some structures, particularly guaranteed and secured wholesale corporate lending, may reflect lending against one or more underlying exposures but with recourse and the true credit risk against the whole business of the obligors rather than just the performance of the underlying exposures.

What do 'tranche' and 'subordination' mean?

> *The definition of 'tranche' is a contractually established segment of the credit risk associated with an exposure or a pool of exposures, where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in another segment, without taking account of credit protection provided by third parties directly to the holders of positions in the segment or in other segments.*

Tranches of debt with differing levels of subordination are an essential feature of almost all public securitisations. However, the regulatory definitions of these terms cover a much broader set of situations, including synthetic transactions where not every tranche takes the form of a debt security, and transactions which - but only due to the other limbs of the 'securitisation' definition - are not securitisations.

As an example, tranched debt is frequently seen in a standard corporate loan context where, through contractual provisions, payment in respect of a shareholder loan is subordinated to or otherwise deferred following payments under a senior loan. Such a transaction, however, would ordinarily involve credit exposure to the borrower's whole business and so not meet the 'dependency upon exposures' test discussed above.

Where there is a need for detailed analysis of tranching, this involves both a binary legal analysis as to the existence of contractual provisions, together with a more qualitative assessment as to whether those contractual provisions have the effect of subordination.

A number of financing structures, such as portfolio acquisitions, are frequently financed via a combination of bank debt and sponsor equity. Such sponsor equity financing could either take the form of subordinated debt or common equity. Where such financing takes the form of common equity, it is generally understood that no tranching of credit risk will arise because common equity is not a contractually established segment of credit risk (its subordination to debt incurred by the company in question being a matter of general law). Additionally, structural subordination, with borrowing occurring at different levels of a corporate structure, does not typically constitute tranching. This is because, while there is subordination in effect between levels of financing, the subordination is caused by the corporate structure rather than contract. Care, however, is needed when considering how cash flows operate between different levels in such a structure. Certain other forms of credit support, such as liquidity facilities and hedging agreements, are generally also not considered as segments of credit risk and so not 'tranches'.

What about 'distribution of losses during the ongoing life of the transaction'?

Some market commentators have argued that, despite the reference in the definition of securitisation to 'an exposure or pool of exposures', structures involving debt backed by a single exposure such as single asset repackaging are generally not capable of constituting a securitisation. Such an argument relies on the basis that tranching of credit risk in respect of such an exposure will not provide for a 'distribution of losses during the ongoing life of the transaction'. Instead, such tranching will only determine the distribution of losses at a single point in time (the time of a default) and so after the end of the ongoing life of the transaction.

While it is reasonable to argue that there must be some meaning attached to the words 'during the ongoing life', care is needed in applying the approach above. The definition of 'tranche' specifically envisages that there may only be a single exposure. Accordingly a very clear link would need to be drawn between the timing of the distribution of losses and the time at which the transaction ceases to have an 'ongoing life'.

What is the extent of specialised lending?

Specialised lending includes certain types of financing structures for physical assets, including project finance, real estate finance, asset finance and commodities finance. Although these financing structures often use techniques which are commonly associated with securitisations, they fall outside the securitisation regulatory framework and have a dedicated capital requirements framework under the CRR. It will not always be possible to confidently categorise a given structure (particularly if it is highly bespoke) as either a 'securitisation' or 'specialised lending', and the difficulty of classification is exacerbated where no party involved is a credit institution and therefore subject to the CRR. A degree of reliance must therefore be placed on perceptions of market participants as to whether a given structure is properly classified as a securitisation or whether it exhibits the characteristics of one of the categories of specialised lending.

How will regulators approach these points?

It may be that regulators (or the courts) will provide further clarity on where the boundaries of a securitisation lie in due course and it may be that national regulators of originators, sponsors and investors have differing views. However, we would expect any enforcement action in this area, at least in the early stages of the new regime, to address egregious or widespread adoption of structures with third party investors which look to circumvent the requirements of the Securitisation Regulation. We would not expect institutions' good faith assessment of unusual structures to be re-examined by regulators absent some particularly compelling reason for them to do so.

2. Is my transaction an 'issuance'?

The new securitisation regime applies to securitisations the securities of which were issued on or after 1 January 2019. There is currently no guidance from regulators as to how to apply the concept of 'issuance' to amendments to existing securitisations. In our view and in the absence of regulatory guidance, a common sense and risk-sensitive approach is prudent (although it may also be possible to seek guidance, at least in the UK context, from the English common law principles of rescission and variation). One should regard new securities as having been issued for the purposes of the Securitisation Regulation if the contractual terms of the existing securities have been altered in some essential way, but if the amendments do not go to the very root of the original contract there should not be deemed to have been a new issuance of securities. Again, this is a distinction of degree rather than kind, so typically an analysis of the specific facts and circumstances is required.

If there has been an increase in commitment beyond an existing level of commitment, we would typically consider this to be a new issuance of securities. An exception to this general position might be argued to exist if the increase of commitment is within an existing accordion. In the case of other commercial changes to a loan, it is a question of whether those particular changes would have the commercial effect a new loan being entered into. For example, the extension of a maturity date for a short period of time due to operational reasons would be at less risk of being categorised as a new issuance than a material extension of maturity in lieu of refinancing an existing facility. In many circumstances a new lender assuming a commitment or retaking existing security should not constitute the issuance of securities.

3. What entities are caught? What is the jurisdictional scope of the regime?

On its face the Securitisation Regulation is fully extra-territorial, imposing obligations on market participants (such as originators, sponsors, original lenders and securitisation special purpose entities) to retain credit risk, meet high credit-granting standards and provide disclosure to investors at the outset and during the life of a transaction as well as on regulated institutional investors (including funds, insurers, investment firms and credit institutions) to undertake due diligence and ensure that credit risk is retained, even if those entities are not established in the EU.

However, given that the provisions relating to supervision and sanctions can only apply to entities established in the EU, a consensus has arisen among market participants that non-EU established entities do not have direct obligations to comply with the securitisation regime in most cases. This means, however, that an EU established sponsor still has an obligation to comply for any securitisation it establishes (even if the assets, the investors and some of the other sell-side entities are located outside the EU).

Unlike the old securitisation provisions of the CRR, which only directly applied to credit institutions, the Securitisation Regulation applies directly to all securitising entities, including non-bank corporate originators. These corporate originators will now be subject to direct regulation by local competent authorities (the FCA in the case of UK corporate originators) in relation to their securitisation activities and for the first time have a direct regulatory interface into their treasury activities.

The definition of 'institutional investor' has been widened and includes within its scope alternative investment fund managers that 'manage and/or markets alternative investment funds in the Union'. On a literal reading, this could potentially include all third country AIFMs which market AIFs in the EU.

Transparency, due diligence, risk retention and credit-granting

4. How should sell-side entities comply with their transparency obligations under Article 7?

EU-established originators, sponsors and securitisation special purpose entities have extensive new transparency obligations both to current and potential investors and to competent authorities. They are required to disclose documentation essential to the understanding of the transaction and, if there is not prospectus, a transaction summary (before pricing), loan-level data and investor reports, on the basis of specified templates (periodically), and Market Abuse Regulation (MAR) and other events-based announcements (on an ad hoc basis). In the case of public securitisations, it is envisaged that this disclosure should be made via an authorised securitisation data repository, or via a website prior to repository authorisation. In the case of private securitisations, no particular method of disclosure is specified.

Although these obligations do not apply directly to non-EU established sell-side entities, under the previous CRR regime some of these entities opted in to the principles-based transparency obligations, to facilitate investment by EU-established institutional investors. As the costs of compliance with transparency obligations have now increased significantly for certain issuers, and, for others. There remain questions as to how to comply in practice, non-EU established sell-side entities have been reconsidering this approach. In any event a practice is emerging for all non-EU public securitisation documentation which may be of interest to EU investors to contain disclosure as to the extent of compliance with the EU securitisation regime.

Is my securitisation private or public?

Sell-side entities of private securitisations are subject to the same obligations as those of public securitisations, other than in relation to MAR and events-based reporting and the requirement to disclose via an authorised securitisation data repository. For the purposes of the securitisation regime, a private securitisation is one for which no prospectus-regime compliant prospectus is required (which is the case if the securities are in high denominations and are not admitted to trading on a regulated market). This distinction is somewhat counter-intuitive, because it includes within its scope both those securitisations admitted to trading on an MTF, which may have a wide distribution and be conventionally thought of as public ('MTF private securitisations'), as well as those securitisations which are not admitted to trading and have a limited number of investors or may even be solely among entities within the same group ('true private securitisations').

In terms of MAR announcements and events-based reporting in particular, this raises a number of difficulties. MAR applies directly to MTF private securitisations as well as public securitisations, but it does not generally apply to true private securitisations. While the Securitisation Regulation appears to mandate events-based reporting for securitisations outside the scope of MAR, the ESMA Securitisation Q&A indicates that the event-based reporting does not apply to private transactions but only applies to public transactions. This appears to contradict the Securitisation Regulation. Current practice is for both MTF private securitisations and true private securitisations to take into consideration the ESMA events reporting templates and a general need for events-based reporting to take place, but not to be strictly bound by the ESMA templates. UK established entities are required to disclose MAR and events-based disclosure to the UK competent authorities on the basis of the Financial Conduct Authority/Prudential Regulation Authority private securitisation template.

Which templates should be used for loan-level data and investor reports?

The latest draft of ESMA's loan-level reporting templates was published at the end of January 2019, including guidance as to which fields may be left incomplete on a 'not applicable' or 'no data' basis. Although significant further changes are not now expected to be made to these, it is likely that they will not be published in the EU Official Journal and formally enter into force until perhaps Q4 2019 and it may be that the application date (the effective date for strict compliance) is some time beyond that. In the interim, the Securitisation Regulation obliges sell-side entities to disclose loan-level data and investor reports using the templates under the Credit Rating Agencies Regulation III (CRA III). Although feasible for some new issuances, this has caused significant problems for certain issuers since the CRA III templates had not been in effect prior to January 2019 and pre-existing documentation and systems did not always contain the necessary information or the right way to obtain it.

However, in November 2018, the joint committee of the European Supervisory Authorities (ESAs) published a letter confirming that they expect national competent authorities to supervise "in a proportionate and risk-based manner" and "take into account the type and extent of information already being disclosed by the reporting entities". This does not amount to a formal no action letter (of the sort that the U.S. Securities and Exchange Commission, but not the ESAs, is empowered to issue) or a general policy of forbearance, but it does give some comfort to market participants that, if they make reasonable and good faith efforts to comply, they are unlikely to be penalised. In order to be able to demonstrate reasonable and good faith efforts, those sell-side entities that choose (or have little choice other than) to deviate from their strict regulatory obligations should document the reasons for their choice. In practice the ESAs' letter operates as an effective transition period.

In terms of practical compliance, market practice is mixed and depends on a range of factors, including the asset class, whether the securitisation is private and the date that the securitisation was established. For some new securitisations, disclosure is already being made on the basis of the draft ESMA templates: this approach seems justifiable given that, in the longer-term, it will give investors continuity of disclosure and ensures costs of disclosure for the sell-side during the life of a securitisation are not disproportionate. For some legacy securitisations (that have been brought within the scope of the new securitisation regime by an increase in commitment or because the STS designation is sought), the question is more complex. Many of these transactions may previously have disclosed loan-level data and investor reports on the basis of market standard documentation or central bank templates. In this case, strict compliance with the securitisation regime would entail two changes, first to the CRA III templates and then to the ESMA templates, which again seems disproportionately costly. Some of these transactions are reporting on the basis of the draft ESMA templates, others are continuing to report on the basis of their existing documentation until the ESMA templates are finalised.

For true private transactions, the question can be even more difficult. Here, the investors may have confirmed that, commercially, they do not require either the ESMA templates or the CRA III templates, but instead prefer a different disclosure standard. UK regulated sell-side entities are required to report to the relevant UK competent authority on the basis of the FCA/PRA private securitisation templates: these are relatively less onerous compared to the ESMA templates, but they are an additional obligation, rather than an alternative obligation, as sell-side entities for private securitisations are still obliged to disclose to investors on the same basis (CRA III/ESMA templates) as public securitisations. Some market participants have adopted the view that 'make available' can be read as meaning 'prepared to make available to an investor upon request', but this approach needs to be considered carefully in context before adoption.

There are many other open questions related to the transparency obligations under the Securitisation Regulation. For some asset classes, it is not clear which is the appropriate template. For some data fields, it is not clear how they should be completed in a meaningful way, for example some data fields seem only to allow numerical data when text might be more appropriate. It may be the case that some transactions require a greater ability to use the 'no data' option or alternatively to use a 'comply or explain' disclosure standard instead. There are considerable uncertainties over the extent to which confidential or GDPR-related sensitive data can be carved out of templates which (in the case of public transactions) will effectively be in the public domain. The uncertain scope of regulatory obligations and the difficulty with complying with the letter of them means that care should be taken to document contractual obligations in the transaction documentation to avoid inadvertently triggering events of default and to ensure that undertakings are appropriately calibrated. For many cross border transactions, the sell-side entities may be established in different jurisdictions which might mean disclosure to a range of national competent authorities is required, some of which may have different requirements.

5. How should investors comply with their due diligence obligations under Article 5?

EU-established institutional investors are required to verify certain matters before becoming exposed to a securitisation, including that the structure is risk retention compliant, that the originator has complied with high credit-granting standards and that the sell-side entities comply with their transparency obligations. They are also required to carry out a due diligence assessment commensurate with the risks involved before investing and, on an on-going basis, maintain written procedures to monitor the performance of the securitisation, to perform stress tests and be able to demonstrate to competent authorities that they have a thorough understanding of their securitisation position and its underlying exposures.

The interplay between due diligence and transparency: can EU institutional investors still invest in non-EU securitisations?

The Article 5 due diligence obligation on buy-side entities and the Article 7 transparency obligation on sell-side entities complement each other. In effect, sell-side entities not only have a direct transparency obligation, they also have an indirect obligation (as was the case under the old regime) to provide sufficient information for investors to be able to perform their own obligations. This raises a number of difficult questions.

Article 5 does not envisage any binding regulatory technical standards or other guidance setting out the standard of verification that a buy-side entity needs to meet in order to comply with the verification obligation. On an extreme view, an investor could not invest if a sell-side entity made some relatively technical or trivial mistake in its templates. This view is surely incorrect, but, in the absence of guidance from one of the ESAs, there is no obvious basis for reading into the text a 'reasonable' or 'proportionate' standard. In the UK, the PRA confirmed in PS29/18 that 'the level and nature of investor due diligence prior to holding a securitisation position may be proportionate to the risks posed to the institutional investors, provided the minimum checks specified in Article 5 are complied with.' This is welcome guidance, but, in the absence of confirmation at European level that this is the correct approach to Article 5, the question will remain somewhat open (at least for non-UK investors).

There has been an extensive industry debate on the extent to which an EU institutional investor may invest in a non-EU securitisation if the sell side does not comply with the letter of EU transparency rules (most likely where it complies with a local standard instead). The text of the Securitisation Regulation is uncertain here and from the text it is possible to find support either for the position that they may or for the position that they may not. For example, 'the originator, sponsor or SSPE has, where applicable, made available the information required by Article7' could be taken to mean 'only where there is a direct legal obligation' and therefore not apply where no sell-side entity is established in the EU. On the other hand, it seems odd that the Securitisation Regime explicitly creates bifurcated verification regimes depending on jurisdiction for risk retention and credit granting, but does not explicitly do this for transparency. This is further complicated by the fact that the underlying policy intent is uncertain. For example, it is possible to argue that EU institutional investors should not find it relatively easier to invest in non-EU securitisations than EU securitisations, but it is equally possible to argue that they should not be effectively shut out entirely from non-EU securitisations and that concentration risk should be reduced.

The joint committee of the ESAs plans to publish guidance on the jurisdictional scope of application of the Securitisation Regulation in the coming months and it is hoped that this question will be addressed. In the interim, investment decisions have to be made whilst factoring in this additional regulatory risk.

6. Risk retention

From a compliance perspective, risk retention is one of the easier parts of the new securitisation regime. This is because, although the new regime made some reforms (the introduction of a direct obligation on sell-side entities to retain risk, the enhanced prohibition on cherry-picking assets and the requirement that risk retaining originators are not established for the sole purpose of securitising exposures), the key elements of the obligation (the level of risk to be retained and the structural methods of retaining risk) are largely unchanged.

The regulatory technical standards setting out the technical detail relating to risk retention are still not in force and the time-table for these has been delayed. This means that sell-side entities currently issuing securitisations are subject to the old risk retention RTS, but any buy-side entities buying into the transaction (for example, on the secondary market) after the application date of the new RTS will have to verify compliance with the new RTS. Assuming that the new risk retention RTS closely reflect the draft version, this should not cause practical problems for most transactions.

The new risk retention obligations may be somewhat more challenging for refinancing certain legacy securitisations. Those that were established prior to the original risk retention obligations under the CRR taking effect in January 2011 may have no risk retention provisions at all. Some securitisations that were established prior to December 2014 took advantage of the wide definition of 'originator' in the CRR by incorporating an SPV originator solely for the purpose of buying a third party's exposures, before immediately securitising them. In December 2014, the EBA opined that these transactions were inconsistent with the spirit of the risk retention requirements. Some of these transactions may therefore require significant restructuring in order to comply with the new securitisation regime.

7. Credit-granting standards

The new credit-granting standards requirement in some respects reflects the existing CRR requirement that securitising entities apply to exposures to be securitised "the same sound and well-defined criteria for credit-granting which they apply to non-securitised exposures" and apply "the same clearly established processes for approving and where relevant amending, renewing and refinancing [such] credits". However, it also goes beyond the CRR requirement by requiring that securitising entities have "effective systems in place to apply those criteria and processes in order to ensure that the credit-granting is based on a thorough assessment of the obligor's credit-worthiness…", language which closely tracks the Mortgage Credit Directive. This obligation may be harder to meet in relation to some asset-classes. Securitisations of self-certified mortgages originated after 20 March 2014 (the date of entry into force of the Mortgage Credit Directive) are prohibited, though self-certified mortgages originated prior to that date may be securitised (and existing securitisations containing such legacy self-certified mortgages may be refinanced). Care should be taken if the portfolio of mortgages to be securitised contains mortgages originated between 20 March 2014 and 20 March 2016, because even though the Mortgage Credit Directive entered into force on the earlier date, it only applies to mortgages originated after the later date.

Originators that purchase pools of receivables (of whatever type) originated after 20 March 2014 from original lenders are required to diligence the credit-granting standards of the original lender to ensure that they meet the above general criteria for credit-granting. In the case of receivables created on or before such date, the diligence requirement of originators on original lenders is the same as the existing diligence requirement contained within the old risk retention RTS, a relatively lower standard. It is somewhat odd to use the entry into force of the Mortgage Credit Directive as a cut-off point in relation to securitisations of all asset classes, but this should not cause many practical problems.

Another issue for the securitisation industry - benchmark reform

Benchmark reform does not fall within the scope of the Securitisation Regulation, but, since Andrew Bailey's speech in July 2017 warning market participants that they should not rely on LIBOR being available after 2021 (and recommending that they develop alternative benchmark rates and ensure that financing documentation has robust fallbacks if publication of LIBOR ceases), this has been one of the most significant legal, operational and commercial questions facing securitisers.

In the last few months there have been a number of new GBP-denominated public securitisations in the UK ABS market that have successfully issued on the basis of a compounded daily SONIA reference rate. For these securitisations, the question arises over whether to allow for the possibility of an easy switch from compounded daily SONIA to term SONIA (as and if that is made available), perhaps using negative consent provisions.

Even though the eventual demise of LIBOR seems inevitable and there is now an established market for SONIA-linked securitisations with relatively standardised documentation, there remain difficult commercial questions for some transactions. If, for example, the portfolio of exposures contains mortgages which are linked to LIBOR, linking the securities to SONIA creates additional interest rate mismatch risk. The speed and approach with which different currencies are transferring to risk free rates varies, which adds to the complexity for those transactions which contain USD or EUR tranches as well as GBP tranches.

After 2021, legacy transactions linked to LIBOR will likely be faced with the choice of either relying on existing fallback provisions (effectively, given the near-certain unavailability of reference bank rates, leading to a reversion to a fixed interest rate, which is unlikely to be popular with investors and may be uneconomic) or undertaking a consent solicitation process (with the attendant costs and risk of noteholder holdouts). This exercise should be more straightforward for those recent transactions which incorporate a variation of the AFME negative consent language.

Conclusion

It is still too early to judge whether or not the new securitisation regime will achieve its aim of revitalising European securitisation markets. It is worth noting that, despite some industry fears, new issuance continues to be possible for most asset classes. Additional regulator guidance on some open questions as well as the finalisation of outstanding secondary legislation could ensure that entities are able to comply with a well-calibrated compliance burden and encourage further issuance. There remains work to do.

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