CAPITAL MARKETS
SECURITISATIONS

Made simple?

The EU's new framework to encourage high quality securitisations contains a revised set of rules together with criteria for simple, transparent and standardised securitisations

From January 1 2019, two important new regulations will apply to securitisation transactions. One of them revises the general rules for securitisation transactions and creates a framework for simple, transparent and standardised (STS) securitisations (Regulation (EU) 2017/2402, amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EC and Regulations (EC) No 1060/2009 and (EU) No 648/2012 (the Securitisation Regulation)). The other amends the existing rules under the Capital Requirements Regulation (CRR) in order to adjust the regulatory capital requirements for securitisation transactions and includes lower regulatory capital requirements for STS securitisations (Regulation (EU) 2017/2401 amending Regulation (EU) No 575/2013 (the CRR Amendment Regulation, and together with the Securitisation Regulation, the Securitisation Regulations)).

The Securitisation Regulations will apply to securitisation transactions where securities are issued (or, in the case of securitisations which do not involve the issuance of securities, where new securitisation positions are created) on or after January 1 2019. After several years in the making, involving a consultation process and proposals by the European Commission, the Council of the European Union and the European Parliament, the finalisation of the Securitisation Regulations is an extremely important step in the development of the securitisation market. The Securitisation Regulations are intended to encourage high quality securitisation as a funding source as part of the EU Capital Markets Union project, while at the same time strengthening the legislative framework to reduce potential risks which were identified in connection with the financial crisis, and harmonising the existing rules.

Main features

One key feature of the Securitisation Regulation is the risk retention requirement. For a number of years now, banks and certain other types of regulated institutional investors have been prohibited from investing in a securitisation unless the originator, sponsor or original lender has disclosed that it will retain a material net economic interest of at least

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Two new EU regulations will apply to securitisation transactions from January 1 2019. The existing rules for securitisations have been consolidated and expanded. The new rules include requirements for risk retention, due diligence and transparency, credit-granting standards and a ban on resecuritisation. In addition, a new framework for simple, transparent and standardised securitisations has been established. Furthermore, the Capital Requirements Regulation has been amended to introduce revised regulatory capital requirements for securitisations. Market participants will need to consider the new rules in detail, together with the technical standards and guidelines which are in the process of being developed.

five percent (the so-called skin in the game requirement, put in place as a result of the financial crisis to mitigate against originate to distribute models).

The Securitisation Regulation does not fundamentally change the risk retention requirements, but consolidates and harmonises the requirements which currently apply to:

- credit institutions and investment firms under the CRR;
- regulated alternative investment fund managers under the Alternative Investment Fund Managers Directive; and
- insurance and reinsurance undertakings under the Solvency II Directive (as supplemented in each case by the applicable regulations).

It also applies them to two new classes of institutional investors:

- certain investment companies authorised in accordance with, and management companies as defined in, the Undertakings for Collective Investment in Transferable Securities Directive; and
- institutions for occupational retirement provision and related investment managers and authorised entities.

However, in addition to this indirect obligation on investors, there is now a direct obligation on the originator, sponsor or original lender to retain a material net economic interest of at least five percent. One consequence of this is that even if a transaction has only non-EU investors, if there is an originator in the EU, the transaction will need to be risk retention compliant.

Investors will also be subject to certain due diligence requirements (which are similar but not identical to those under the CRR). Investors will be required to confirm that the originator and the other relevant parties have complied with the credit-granting criteria, risk retention and transparency requirements and will also be required to carry out a due diligence assessment before investing in a securitisation. The jurisdictional scope of the due diligence requirements is not clear but it seems likely that they will apply only to EU regulated investors, with the possible exception of consolidated affiliates of EU institutions. It is hoped that this will be clarified.

Another key feature of the Securitisation Regulation relates to disclosure of information to investors. The transparency requirements are based upon those established by the amendments to the Credit Rating Agencies Regulation pursuant to the regulation known as CRA3. This introduced extensive disclosure requirements, and for some asset classes detailed forms of reporting templates were produced. However, to date it has not been possible to comply with the reporting requirements as the website on which the information is to be published has not yet been established.

The revised transparency requirements will require originators, sponsors and special purpose vehicles to disclose the prospectus (or if there is no prospectus, a summary of the transaction) and the main transaction documents, to provide investor reports on a quarterly basis, or on a monthly basis in the

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In order to prevent cherry-picking, the Securitisation Regulation prohibits an originator, sponsor or original lender from selecting assets for the securitisation with the aim of rendering the losses on securitised assets higher than for retained assets. However, it is expected that assets with a higher than average credit risk profile compared with the average credit risk profile for comparable retained assets will be permitted to be securitised provided that this is communicated to investors.

case of securitisations funded via asset-backed commercial paper (ABCP), with data on the credit quality and performance of the underlying exposures, trigger events and information on risk retention, and to notify investors of certain matters, all of which should be provided via a securitisation repository, or if no securitisation repository has been registered, via a website that meets certain requirements. In the case of certain private transactions (ie transactions where a prospectus is not required to be prepared under the Prospectus Directive) it is not necessary to provide the information to a repository or a website, but disclosure will still be required to be made to investors. The transparency requirements represent substantial obligations for originators, sponsors and special purpose vehicles, particularly with respect to so-called loan-level data.

In addition to the above requirements, there are detailed credit-granting standards, restrictions on special purpose vehicles being established in certain jurisdictions, and a ban on resecuritisation transactions (being securitisations where at least one of the underlying exposures is a securitisation transaction).

STS requirements

The STS framework consists of a set of requirements for non-ABCP securitisations and for ABCP securitisations (at transaction, sponsor and programme level), in order for them to be considered to be STS.

The CRR Amendment Regulation puts in place a revised framework for the assessment of regulatory capital requirements for securitisation transactions based on (but with some changes from) the revised securitisation framework in Basel III. As a result, the amount of regulatory capital required to be held by EU banks against their securitisation positions will (except in the case of certain lower credit quality tranches) be significantly increased, potentially putting securitisation at a disadvantage to other funding methods. If all the applicable STS criteria are met and this is appropriately notified to the European Securities and Markets Authority (Esma), and if additional criteria in the CRR Amendment Regulation are also satisfied, the regulatory capital requirements for the applicable securitisation positions will be reduced from the new levels under the CRR Amendment Regulation which will apply to non-STS securitisations.

The STS framework is very detailed and covers a variety of matters including true sale, requirements in relation to the assets being securitised, servicer expertise, interest rates and matters which need to be specified in the transaction documents. STS securitisations will also have favourable treatment under Solvency II capital standards for insurance and reinsurance companies, the bank liquidity coverage ratio and the Money Market Funds Regulation.

Despite the clear incentive to ensure that a transaction is STS, there are a number of limitations. One important point to note is that only transactions where all of the originator, sponsor and special purpose entity are in the EU will be capable of being STS. Transactions with UK originators and EU investors, or vice versa, will be unable to benefit from the lower capital requirements after Brexit unless a solution is found. The STS framework will not work for managed collateralised loan obligations (because there can be no active portfolio management on a discretionary basis) and commercial mortgage-backed securitisation transactions generally will not be STS (because repayment must not depend predominantly on the sale of the underlying assets). Synthetic transactions are also not capable of being STS although consideration will be given to establishing an STS framework for balance sheet (but not arbitrage) synthetic securitisations.

It is also worth noting that for an ABCP programme to be considered STS, the STS requirements will need to be met for the programme, the sponsor and all transactions in the programme (except for a limited exception from certain requirements with respect to a maximum of an aggregate amount of five percent of the underlying exposures, on a temporary basis). Finally, there are a substantial number of criteria to be met for a transaction to be considered to be STS, and it is not currently clear how a number of the requirements should be interpreted.

Looking ahead

Various technical standards are required to be put in place setting out further details of the provisions under the Securitisation Regulations. Draft regulatory technical standards have already been circulated, and commented upon by market participants, with respect to risk retention, transparency (both on the periodic information and investor reports to be provided and on the reporting templates), the meaning of homogeneity (as regards the securitised assets in the context of the STS requirements), registration of securitisation repositories and STS notification requirements.

Legacy securitisations may not be fully grandfathered and may fall within the scope of the new rules in certain circumstances

Market participants are particularly keen that the transparency reporting templates are finalised as soon as possible, as if they are not in place by January 1 2019, the CRA3 forms will apply and they will subsequently need to adjust their systems again to reflect the new Securitisation Regulation templates. Esma has recently accelerated its timeline for delivery of their report on the new standards in order to address this issue. In addition, draft guidelines have recently been published by the European Banking Authority with respect to the STS requirements, and these will be very important in interpreting the criteria.

Non-compliance with the requirements of the Securitisation Regulation could result in administrative sanctions in the case of negligence or intentional infringement, including fines of at least €5 million ($5.9 million approximately) or up to 10% of annual net turnover, and other remedial measures, and there is also the possibility of criminal penalties if imposed by the applicable EU member state.

While the Securitisation Regulations will apply to securitisations the securities of which are issued (or if this is not applicable, where the securitisation positions are created) after January 1 2019, legacy securitisations may not be fully grandfathered and may fall within the scope of the new rules in certain circumstances, so this will need to be considered carefully.

Despite the lengthy discussions which have taken place in relation to the Securitisation Regulations, and the detailed submissions from industry bodies, banks and other organisations, there are still a number of points which would benefit from further clarification, including the jurisdictional scope of certain provisions which remains unclear. However, despite the fact that the Securitisation Regulations contain substantial obligations and significant new provisions, many market participants will have been relieved that certain of the proposals made during the legislative process did not make it into the final forms, such as the potential increases to the risk retention percentage which were seen as potentially prohibitive to structuring securitisation transactions.

Market participants welcome this legislative recognition that securitisation has an important role to play in sustainable financial markets, although it remains to be seen how avidly they will embrace the new STS regime. In any event, the finalisation of these new rules should now allow the market to move forward.

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