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Legal Update

Recommendations for developing the EU securitisation market – Report by the High Level Forum on Capital Markets Union

INTRODUCTION

A recent report, entitled "A New Vision for Europe's Capital Markets"[1] (the **"Report"**), sets out some key recommendations for how the EU securitisation market can be scaled up. The Report has been published by the High Level Forum on the Capital Markets Union (the **"HLF"**) which was established by the European Commission (the **"Commission"**). The recommendations cover some key areas of interest for market participants.

BACKGROUND

Capital Markets Union has been an important part of the European regulatory agenda for some time, and was the subject of an Action Plan adopted by the Commission in September 2015.[2] The HLF is composed of experts in the European capital markets, alongside a number of observers from European supervisory bodies and institutions. The views expressed in the Report are those of its members and not the Commission. Nonetheless, the views expressed in the Report are expected to inform the future work of the Commission.

1 A new Vision for Europe's capital markets – Final Report of the High Level Forum on the Capital Markets Union, published on 10 June 2020, available at https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf.

2 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – Action Plan on Building a Capital Markets Union, 30 September 2015.

The Report makes seventeen sets of recommendations in relation to different aspects of the EU markets. In this Legal Update, we have focused solely on the recommendations relating to the EU regulatory framework which applies to securitisation.

THE REPORT

The Report expresses clear support for securitisation and recognises the important role that securitisation transactions can play in the European economy. It notes that securitisation offers opportunities for investors to invest in credit exposures that otherwise would not be available to them. Credit risk can be diversified so that it does not solely stay with banks, and instead other funding sources can be accessed. Banks can also free up their balance sheets which gives them more opportunities to provide funding, in particular to small and medium-sized enterprises (SMEs). Securitisation also provides financing to specialist lenders who provide loans to borrowers who are not served by bank lending. In addition, it is recognised that securitisation can have a key role in dealing with the economic effects of the COVID-19 pandemic. Given these benefits, the Report recommends a review of various items with a view to making targeted and prudentially sound modifications which would improve the regulatory regime for securitisation.

It is worth keeping in mind that the regulatory regime applying to EU market participants in securitisations has developed significantly since the financial crisis. Investors have for a number of years been required to ensure compliance with risk retention and other requirements, and the Securitisation Regulation,[3] which became applicable from 1 January 2019, further expanded and consolidated the rules relating to securitisation, including the introduction of direct risk retention obligations for originators, sponsors and original lenders, enhanced transparency obligations and a framework for "simple, transparent and standardised", or "STS", securitisation. In addition, regulatory capital requirements have been increased in various respects, including under the amended Capital Requirements Regulation[4] (the **"CRR"**). This means that securitisations are generally subject to significantly higher regulatory capital requirements than they were previously, and this is out of line with the capital requirements for non-securitised exposures and other products such as covered bonds. Given that European securitisations have for the most part performed well in recent years, the Report suggests that there has been an overreaction in terms of the regulatory regime and that some streamlining of the regulations is required. It is also noted that the STS framework is very conservative and this has prevented it from reaching its objective.

The recommendations relating to securitisation in the Report cover the following areas:

- unlocking the significant risk transfer (**"SRT"**) assessment process;
- recalibrating the capital charges which are applicable to senior tranches under the CRR;
- recalibrating the capital charges for securitisation tranches under the Solvency II regime;[5]
- reducing the costs of SME financing;
- equivalent regulatory treatment for cash and synthetic securitisations;
- upgrading the eligibility of senior STS and non-STS tranches in the Liquidity Coverage Ratio (the **"LCR"**); and
- differentiating the disclosure and due diligence requirements for public and private securitisations.

UNLOCKING THE SRT ASSESSMENT PROCESS

The Report proposes that the Commission should review the SRT assessment process and recalibrate when an advance (or "ex-ante") assessment by the competent authority is required. It states that, provided the required quantitative and qualitative criteria are met and the transaction is in line with standard market practice, it should not be necessary for the regulator to carry out a systematic review of the transaction in advance. Such an assessment should be limited to those complex transactions that include structuring features that diverge from generally accepted market standards and/or from the quantitative and qualitative criteria set out in the CRR.

Market participants are likely to welcome these proposals as they would make the process of achieving SRT quicker and simpler for market standard transactions, and would provide certainty as to whether SRT can be achieved. This could then free up capital for the banks.

RECALIBRATING CAPITAL CHARGES APPLIED TO SENIOR TRANCHES UNDER THE CRR

The Report proposes that the following should be considered:

- recalibration of the capital charges applicable to senior tranches in line with their risk profile and reduction of risk weighted capital floors (especially for originator and sponsor banks);
- establishing risk-sensitive calculations of the weighted average maturity (WAM) of tranches for both cash and synthetic securitisations;
- reviewing the loss given default (LGD) input floors; and
- encouraging further development of the European non-performing exposure securitisation market.

3 Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

4 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, as amended.

5 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast), as amended.

Making regulatory capital requirements more risk-sensitive, particularly in comparison with other products like covered bonds and the requirements for non-securitised exposures, would be extremely helpful and would assist banks in holding securitisation exposures.

RECALIBRATING CAPITAL CHARGES FOR SECURITISATION TRANCHES UNDER THE SOLVENCY II REGIME

The Report proposes a review of whether the capital charges for securitisation positions applicable to insurers under Solvency II should be recalibrated in order to reduce the gap, and in some cases realign the capital charges, between STS securitisations and covered/corporate bonds, STS and non-STS securitisations and senior and non-senior tranches.

Such amendments are likely to be beneficial in encouraging insurance companies to invest in securitisations.

REDUCING THE COSTS OF SME FINANCING

The Report recommends that the Commission should encourage significantly higher investment in SMEs. The proposals concern data collection and disclosure. It suggests the creation of an EU version of the US EDGAR system and that rules are made to ensure credit data and filings will be compatible with this database. It is envisaged that the central collection of such information will facilitate the financing of SMEs by means of securitisation. In addition, efforts should be continued to improve credit underwriting standards and reduce non-performing loans in the SME sector.

EQUIVALENT REGULATORY TREATMENT FOR CASH AND SYNTHETIC SECURITISATIONS

The Report recommends that the Commission should consider extending the STS framework to synthetic securitisations and granting preferential regulatory capital treatment to senior tranches of synthetic securitisations which meet the STS requirements. This follows the recent report by the European Banking Authority on this topic.[6]

The development of an STS framework for synthetic securitisations, together with reductions in the regulatory capital requirements, would be a very welcome development which would facilitate the development of this market.

UPGRADING THE ELIGIBILITY OF SENIOR STS AND NON-STS TRANCHES IN THE LCR

The Report proposes that the Commission should consider whether the eligibility criteria for the LCR should be amended. This would involve the following:

- upgrading the treatment of large senior tranches of STS securitisations;
- allowing senior tranches which formerly qualified as Level 2B to requalify even if they do not meet all the requirements.

It had been hoped that, under the new regime, exposures to STS transactions would be able to be treated more favourably for LCR purposes in recognition of their STS status, and in line with the treatment of covered bonds, but instead STS securitisation exposures are currently treated as Level 2B, while asset-backed securities can no longer qualify as Level 2B securitisations unless they are STS.

If this could be remedied, it is likely that this would significantly incentivise banks to acquire senior securitisation positions, both STS and non-STS.

DIFFERENTIATING THE DISCLOSURE AND DUE DILIGENCE REQUIREMENTS FOR PUBLIC AND PRIVATE SECURITISATIONS

The Report proposes simplifying and clarifying the due diligence and disclosure provisions of the Securitisation Regulation.

Firstly, it is proposed that the disclosure requirements under the Securitisation Regulation should be different depending on whether the securitisation is public[7] or private. It is recommended that the disclosure technical

6 Please see our Legal Update - EBA publishes its report on the creation of an STS framework for synthetic securitisations, available at https://www.mayerbrown.com/en/perspectives-events/publications/2020/06/eba-publishes-its-report-on-the-creation-of-an-sts-framework-for-synthetic-securitisations.

7 Public securitisations are those where a prospectus is required to be drawn up under the Prospectus Regulation (Regulation (EU) 2017/1129 of the European Parliament and of the Council of 4 of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC).

standards[8] being developed under Articles 7(3) and 7(4) of the Securitisation Regulation should only apply to public securitisations. In relation to private securitisations, a proportionate approach should be allowed with respect to the due diligence and disclosure requirements, with reference to the risk profile of the securitisation.

In addition, it is suggested that it should be possible to allow "No Data" fields to be used in the reporting templates in the long term and, where the use of "No Data" fields needs to be reduced, to allow for a transition period.

Furthermore, it is proposed that it should be clarified that Article 5(1)(e) of the Securitisation Regulation does not apply with respect to third-country securitisations, i.e. where the originator, sponsor or securitisation special purpose entity (**"SSPE"**) are not established in the EU. Instead, EU-regulated investors would be able to meet their due diligence obligations under Article 5 if they receive sufficient information which is proportionate to the risk profile of the securitisation.

Finally, securitisation of legacy portfolios should be facilitated by allowing entities that acquire such portfolios to re-underwrite the loans. The suggested amendment would allow an originator which purchases exposures from a third party and then securitises them to carry out due diligence with respect to compliance with the credit-granting requirements, which would be disclosed to investors.

The above points are particularly significant. The completion of the detailed asset-level reporting templates is expected to be time-consuming and onerous, and may not be considered to be of much value in some private transactions, for example, in a trade receivables transaction where the banks will be working closely with the originator in structuring the transaction and will in any event specify detailed requirements for the information they require to be included in the reports. The recognition of the need for proportionality will be welcomed.

In many cases originators and banks will welcome some flexibility and tolerance as to the use of "No Data" options under the reporting templates, for example, where data is not easily available or where it is difficult to complete the templates.

The interpretation of Article 5(1)(e) of the Securitisation Regulation has been the subject of much debate with respect to EU investors involved in securitisations where the originators, sponsors or SSPEs are not established in the EU. Article 5(1)(e) provides that an institutional investor (other than an originator, sponsor or original lender) must verify that "the originator, sponsor or SSPE has, where applicable, made available the information required by Article 7 in accordance with the frequency and modalities provided for in that Article". The jurisdictional scope of this requirement is not explicitly specified. Whilst it is generally agreed that Article 7 does not apply directly to non-EU entities, it is not clear from the wording of Article 5(1)(e) whether institutional investors, as part of their due diligence obligations, need to verify that originators, sponsors and SSPEs which are not established in the EU have provided the relevant information in accordance with the Article 7 requirements. This issue is causing significant practical issues. Asset-level data may not be required for a particular type of transaction or asset class in the originator's jurisdiction, and in cases where asset-level data is required it may not be provided in the form of the reporting templates. While clarification that Article 5(1)(e) does not apply to such third country securitisations will certainly be welcomed, the recommendation indicates that it will still be necessary for EU investors to obtain some information, and it will be essential that the wording of this requirement is sufficiently clear for investors to be able to determine with confidence whether they have complied with their obligations.

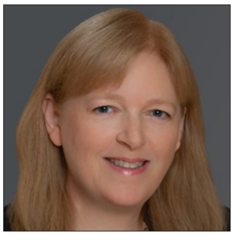
Verifying compliance with the credit-granting requirements has been a practical problem for some securitisations involving legacy portfolios and the proposed wording would go some way towards facilitating these transactions.

8 The regulatory technical standards specifying the information that originators, sponsors and securitisation special purpose entities are required to provide in order to comply with their transparency obligations under Article 7 of the Securitisation Regulation, and the related implementing technical standards regarding the reporting templates, have been adopted by the Commission but are not yet in force.

CONCLUSION

The above recommendations reflect issues which have been discussed by market participants for some time, and as such are likely to be received very positively. There are also other issues which have been raised by market participants which have not been addressed in the Report. Given the urgent need to revitalise the European economy, particularly in the wake of the COVID-19 pandemic, it is likely that a piecemeal approach will not be sufficient and a comprehensive package of reforms will have the most impact on the securitisation market. In terms of next steps, some of the reforms depend on amendments to the Level 1 text, which will require the agreement of the European Parliament and the Council as well as the Commission. Certain reforms may take longer if they are to be aligned with the Basel regulatory capital requirements. Where issues may be clarified by providing guidance, for example with respect to due diligence requirements, it would be beneficial if this could be provided quickly. While any changes may take some time to put into effect, many market participants will be keen to see progress as soon as possible in order to facilitate the expansion of the European securitisation market and to allow increased funding to be provided to the European economy in the near future.

Contacts



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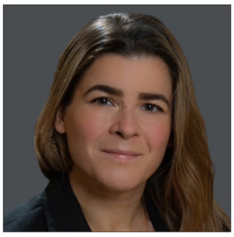

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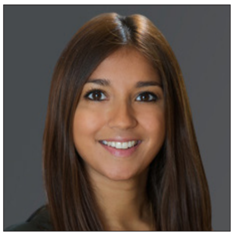

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