COPUBLISHED FEATURE

EU SECURITISATION REGULATION AND THE AUSTRALIAN MARKET

On 10 October 2022, the European Commission published its long-awaited report on the functioning of the EU securitisation regulation[1]. While some Australian market participants issuing securities into Europe have complied to varying degrees, the report gives clarity on the commission's intent that offshore issuers comply in full with the EU securitisation regulation. There are a number of key points in the report, discussed in more detail by a group of lawyers from Mayer Brown: Amanda Baker, Neil Hamilton, Paul Jorissen, Stuart Litwin and Jon Van Gorp.

Due diligence and transparency. The European Commission (EC) has invited the European Securities and Markets Authority (ESMA) to prepare a dedicated template for private securitisations in order to "simplify considerably the transparency requirements for private securitisations" and to review all the disclosure templates to address possible technical difficulties in completing certain data fields, remove possibly unnecessary fields and align them more closely with investors' needs.

The commission invites ESMA to "consider whether information on a loan-by-loan basis is useful and proportionate to investors' needs for all type of securitisations".

Jurisdictional scope. The EC has provided legal interpretation of article 5(1)(e) of the EU securitisation regulation, the effect of which is that EU-based institutional investors are required to verify that sell-side parties will make available the same disclosure and template reporting, including loan-level data, for Australia and other third-country securitisations as is required for EU securitisations.

Risk retention and private securitisations. The commission's latest update does not recommend any change to the existing risk-retention requirements or to the current definition of a "private" securitisation.

Prudential treatment of securitisations. The commission will not make any decision on changes to the prudential treatment of EU securitisations for banks and insurance companies until it has received a response to its call for advice from European supervisory authorities.

BACKGROUND

The report fulfils the EC's legal mandate under article 46 of the EU securitisation regulation to report to the European Parliament and European Council on the functioning of the EU securitisation regulation. The report also contains the commission's formal response to issues raised by the European supervisory authorities (ESAs)' opinion to the EC on jurisdictional scope, by providing legal interpretation of article 5(1)(e) and certain other provisions of the EU securitisation regulation.

The report draws on a number of sources, including the report[2] and opinion[3] of the Joint Committee of the ESAs and feedback from a public consultation.

The report covers risk-retention requirements, due diligence and transparency requirements, the rules for and definition of private securitisations, the case for a simple, transparent and standardised (STS) equivalence regime, a regime for sustainable securitisation, the function of third-party verification of STS, and the case for establishing a system of limited-licence banks to replace the current structure of true-sale securitisation built around securitisation special purpose entities (SSPEs). It also assesses the current state of supervision and the prudential treatment of EU securitisations.

GENERAL CONCLUSION

The commission's opinion is that the EU securitisation regulation seems overall to be fit for purpose. It does not see the need for major legislative change at this juncture, although the report acknowledges that there is "room for fine tuning on certain aspects". The report is clear that European institutional investors must verify that any entity issuing into Europe – regardless of whether it is European or offshore domiciled – will fully comply with the transparency requirements of the EU securitisation regulation.

THE REPORT IN DETAIL

Risk-retention requirements. The commission did not find any evidence of deficiencies in how the risk-retention framework is being applied or that any of the risk-retention methods allowed by the EU securitisation regulation was inadequate. Accordingly, the commission saw no need to revise the existing risk-retention requirements.

To the relief of market participants, the commission rejected the view of the joint committee that only EU-based entities should be able to retain risk.

The report notes that the final draft regulatory technical standards on risk retention[4] have not yet been adopted by the commission and that this may have resulted in some legal uncertainty for market participants.

Due diligence and transparency. The commission has taken account of industry feedback that the existing due diligence and transparency requirements are too prescriptive and strict, especially when compared with the requirements for similar instruments such as covered bonds. The report also acknowledges that market participants see a "lack of proportionality" in the application of transparency rules to third-country securitisations.

The commission's conclusion is that the usefulness of the disclosure templates "might indeed be limited". Accordingly, the commission has invited ESMA to review the disclosure templates for underlying exposures in securitisations, in order to address "possible technical difficulties in completing the information required in certain fields, remove possibly unnecessary fields and align them more closely with investors' needs".

Importantly, the report also states that "ESMA should consider whether information on a loan-by-loan basis is useful and proportionate to investors' needs for all types of securitisations".

Private securitisations. Private securitisations are securitisations where a prospectus has not been drawn up in accordance with the European Prospectus Directive[5] – and so include securitisations listed on exchanges such as the global exchange market of Euronext Dublin or the Luxembourg MTF. Private securitisations are subject to the same regulatory requirements as public securitisations, except they are not currently[6] required to use a securitisation repository to disclose the information prescribed by article 7 of the EU securitisation regulation.

The commission noted industry feedback that transparency requirements for private deals are overly prescriptive and "rather meaningless" for investors in practice, because "investors in private deals are in a position to request and continuously receive the tailor-made information they need from the sell side of the transaction".

Many responses to the consultation favoured amending the definition of private securitisation, so as for example to exempt intragroup transactions with third-party investors. However, the commission's view was that it was not appropriate to change the definition and that moving to a simplified disclosure template for private transactions was the best way to address the issue.

To this end, the commission invited ESMA to draw up a dedicated template for private securitisation transactions that is tailored particularly to supervisors' need to gain an overview of the market and of the main features of private transactions. The commission envisages that this new template could replace the existing templates for all private securitisations, ie there could be a single template for all asset classes.

ESMA has now initiated a consultation in relation to this review process. A number of industry commentators have suggested that a revised template for private securitisations

"The committee's decision to invite ESMA to revise and simplify the disclosure templates is a welcome development. In particular, the development of a dedicated template for private securitisations should materially ease the administrative burden for participants in private deals."

should be principles-based rather than requiring completion of pre-set data fields.

Jurisdictional scope. The jurisdictional scope of the EU securitisation regulation is further-reaching than expected and is not consistent with the approach offshore issuers have taken. Accordingly, we expect to see some shift in the market in terms of full compliance.

Sell-side obligations. The commission rejected the view of the joint committee that articles 6 (covering risk retention), 7 (transparency requirements) and 9 (credit-granting criteria) of the EU securitisation regulation should be interpreted in such a way that they could only be fulfilled by EU-based entities, which would enable these obligations to be enforced directly by EU regulators.

The commission concluded that these obligations could be effectively enforced through institutional investors' due diligence obligations under article 5. Under these, before investing in a securitisation, an investor must verify that the sell-side parties, irrespective of their location, comply with their respective obligations.

Buy-side obligations – availability of disclosures. The provisions of the report with the most significant immediate impact relate to the issue of the disclosure and reporting required to be made available to EU institutional investors in order for them to be able to invest in Australian or other third-country securitisations.

Article 5(1)(e) of the EU securitisation regulation requires institutional investors to 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".

For many years, there has been uncertainty as to the application of article 7 disclosure requirements to third-country securitisations, in particular whether EU investors have to verify that information will be provided in the form of prescribed ESMA templates, including loan-by-loan data on the underlying exposures.

The commission noted that article 5(1)(e) gives rise to questions of legal interpretation and that its requirements were interpreted and applied differently by market participants. However, the commission concluded that differentiating the scope of information to be provided, depending on whether the securitisation is issued by EU entities or by entities based in third

"The commission's legal interpretation of the jurisdictional scope of the EU securitisation regulation creates significant practical compliance issues for Australia and other third-country sell-side parties in the interim period before any new templates are adopted. It is therefore to be hoped that industry calls for some form of 'no action' or transitional relief meet with a positive response."

countries, is not in line with the legislative intent. This is because it "does not matter for the proper performance of the EU-based institutional investors' due diligence whether a securitisation originated inside or outside the EU".

The commission stated that "it is not appropriate to interpret article 5(1)(e) in a way that would leave it to the discretion of institutional investors to decide whether or not they have received materially comparable information".

The commission noted that it was aware that this interpretation "de facto excludes EU institutional investors from investing in certain third-country securitisations", because third-country sell-side parties "might not be interested in providing the necessary information according to the procedures set out in article 7".

The commission noted that its request to ESMA to revise the disclosure templates and produce a dedicated template for private securitisations "might help reduce the competitive disadvantage for EU institutional investors", because it would make it easier for third-country sell-side parties to provide the required information.

The commission's legal interpretation, while providing the certainty the market has requested for some time, is problematic for sell-side parties in Australia and other third-country securitisations and also for EU institutional investors in those securitisations.

Although the commission sought to mitigate the effect of its legal interpretation of article 5(1)(e) by holding out the prospect of a new simplified template for private transactions, it is likely that the process required for the adoption of new templates would take a minimum of a year, and probably significantly longer.

During the transition period between the report's publication and the adoption of new templates, Australia and other third-country originators may baulk at investing the time, expense and resources necessary to complete the existing templates, especially when simplified templates are likely in the near term.

For some transactions and asset classes, it may be practicable for originators to complete the existing templates without significant cost or administrative burden, for instance by using the services of specialist third-party reporting agents or with support from buy-side parties. But this will not always be the case.

Since the report is not a change of law but rather sets out the commission's interpretation of existing law, it does not contain any express grandfathering or other transitional provisions. In relation to existing holdings of securitisations that do not fully comply with article 7 requirements and which were acquired before the report was published, it is generally considered that immediate sale should not be required.

In particular, alternative investment fund managers (AIFMs) are required to act in the best interests of the alternative investment funds (AIFs) or of the investors in the AIFs they manage[7], and accordingly a fire sale of existing noncompliant securitisation positions held by AIFs should not be required.

In relation to future investments by EU institutional investors in third-country securitisations, the commission's legal interpretation of article 5(1)(e) will almost certainly be treated as binding by national competent authorities. Accordingly, in making investment decisions, investors will need to be fully aware of the commission's interpretation and assess from a risk perspective the likelihood and nature of regulatory sanctions in relation to any potential exposure to securitisations that do not fully comply with article 7 reporting requirements.

It should be noted that article 7 also requires certain disclosures to be made available to investors before pricing – including transaction documents, which will typically be made available before pricing in draft form on a dedicated website, subject to finalisation on or around closing.

Buy-side obligations – AIFM investors. The commission also responded to the joint committee's request for legal clarification in relation to AIFMs acting as institutional investors in securitisations.

The commission concluded that AIFMs that manage or market funds in the EU have to comply with the due diligence obligations of the EU securitisation regulation. However, these obligations "should apply only to the funds that the third-country AIFM markets and manages in the EU, but should not be construed as also covering the management and marketing activities of this same AIFM that has no link to the EU".

The commission stated that it would consider amending the wording of article 2(12)(d) specifically to remove any kind of legal uncertainty in a future proposal to amend the EU securitisation regulation.

In addition, the commission concluded that the definition of "institutional investor" in article 2(12) of the EU securitisation regulation includes "sub-threshold" AIFMs[8].

STS equivalence. The EC stated that, to date, no securitisation regime in a third-country jurisdiction would come close to being considered equivalent to the EU's STS framework, despite the UK's substantially wholesale adoption of the EU's own STS regime after the UK left the EU. The commission therefore considered that it was "premature to introduce an STS equivalence regime at this time".

The commission noted that the EU STS regime is still evolving, and the EU has recently established a regime for STS on-balance-sheet securitisations that does not exist in the UK.

This contrasts with the UK Treasury report on the functioning of the UK securitisation market[9], which concluded that an STS equivalence regime "is desirable and should be introduced at the appropriate time". The UK has also proposed to extend its temporary recognition of EU STS securitisations to the end of 2024[10].

Sustainable securitisation. The EU securitisation regulation currently imposes only a limited obligation to make sustainability disclosures. For STS securitisations, the sell-side party has to publish "available information" on the environmental performance of the assets financed by residential loans or auto loans or leases[11].

The 2021 amendments to the EU securitisation regulation added the option, from 1 June 2021, for originators to publish available information on the principal adverse impact (PAI) on sustainability factors of the assets financed by the underlying residential loans or auto loans or leases. To date, a couple of Australian residential loan securitisations issued into Europe have provided information on sustainability.

Article 45a(e) of the EU securitisation regulation requires the commission to report on the creation of a specific sustainable securitisation framework, on the basis of a report by the European Banking Authority (EBA) published on 2 March 2022[12]. The commission agreed with the EBA report that there was no need for a separate green securitisation label in the short or medium term, and invited legislators instead to address the issue in the ongoing negotiations on the creation of a European Green Bond Standard.

The joint committee is developing regulatory technical standards (RTS) that will specify the information to be provided on the PAIs of certain asset classes included in STS transactions. The EBA report recommended that the scope of PAI disclosure should be extended: in the short term, to non-STS securitisations backed by the same asset types as in the existing STS disclosure requirement and, in the medium term, to all securitisations.

The commission also recognised the need to develop PAI disclosures and considered that the scope of the RTS from the joint committee should be as wide as possible.

Third-party verification of STS criteria. The EU securitisation regulation established a system of third-party verification entities to assist issuers and investors in assessing the compliance of a securitisation with the STS criteria.

In order for a third party to verify compliance with the STS criteria, it must be authorised by ESMA. It is then supervised by the national competent authority of the EU member state in which it is incorporated. The engagement of a third-party verification agent does not, however, remove legal liability from originators, sponsors and institutional investors in respect of the notification of a securitisation transaction as STS.

The commission concluded that the third-party verification regime appears to function as intended and saw no need to revise provisions regarding this regime. However, it recommended that dialogue should take place at an appropriate frequency between national competent authorities and the third-party verification firms to avoid inconsistent interpretations of the STS criteria.

SSPEs. The commission was mandated to enquire whether a system of limited licensed banks, which would perform the functions of SSPEs and have the exclusive right to purchase exposures from originators and sell claims backed by those exposures to investors, would add value to the securitisation framework.

Reflecting industry feedback, the commission concluded that there was no need to introduce a system of licensed banks to perform the functions of SSPEs. "The current framework is working in an adequate manner and no shortcomings or issues to address with regard to SSPEs have been identified."

Supervision of securitisation. The commission noted that to date no major shortcomings in supervision had been reported – in particular, no issues requiring changes in legislation. The commission saw this as an indication of the overall appropriateness of the supervisory framework.

The commission noted that the securitisation market was not equally developed across the EU and that this has had an impact on the degree of experience of the different supervisors.

The commission agreed that a common EU guide covering best practices for national supervisors should be developed and also saw merit in exploring the feasibility of having a lead supervisor.

Prudential treatment of securitisations. The report does not make any recommendations in relation to the prudential treatment of securitisations for banks and insurance companies. This is because the commission has addressed a call for advice to the Joint Committee of the ESAs, asking it to assess whether the securitisation prudential framework has met its intended objectives and to assess the appropriateness of the current regulatory capital requirements for investments in securitisations[13]. The commission will wait for the joint committee's advice and recommendations before making any possible decisions on the current prudential regime.

Significant risk transfer. Achieving regulatory significant risk transfer (SRT), and the associated regulatory capital relief, is one of the primary considerations for originator banks when structuring securitisation. Articles 244 and 245 of the capital requirements regulation (CRR)[14] permit banks to make their own determinations as to whether SRT requirements are satisfied, based on specified quantitative and qualitative tests.

However, originators must seek their competent authority's assessment of compliance with those tests. Banks have long contended that the SRT framework is an obstacle to growth of the securitisation market because of uncertainty and inconsistency of the supervisory assessment outcomes. The report notes that the commission is currently considering

COPUBLISHED FEATURE

"The EC stated that, to date, no securitisation regime in a third-country jurisdiction would come close to being considered equivalent to the EU's STS framework, despite the UK's substantially wholesale adoption of the EU's own STS regime after the UK left the EU."

whether to use its powers under the CRR to adopt a delegated act to enhance the harmonisation of the SRT framework, based on the EBA's report of 23 November 2020[15] and on industry feedback.

UK SECURITISATION FRAMEWORK

The report has no direct application to UK securitisation or UK investors. UK institutional investors may currently still exercise their own discretion as to whether reporting made available in respect of Australia or other third-country securitisations is "substantially the same"[16] as that provided in respect of a UK securitisation.

However, sell-side parties will need to take care that offering documents for securitisations being sold into both the EU and the UK clearly distinguish between the differing due diligence obligations of EU institutional investors and those of UK institutional investors.

In its report on the functioning of the UK securitisation regulation[17], HM Treasury said that UK regulators would, as a priority, seek to clarify what kind of disclosures are required for securitisations where the manufacturers are established outside the UK. This would "aim to balance pragmatism with high disclosure standards". It remains to be seen whether UK regulators will follow the approach of the commission.

CONCLUSION

The committee's decision to invite ESMA to revise and simplify the disclosure templates is a welcome development. In particular, the development of a dedicated template for private securitisations should materially ease the administrative burden for participants in private deals.

The commission's legal interpretation of the jurisdictional scope of the EU securitisation regulation, while providing certainty for the market, creates significant practical compliance issues for Australia and other third-country sell-side parties in the interim period before any new templates are adopted. It is therefore to be hoped that industry calls for some form of "no action" or transitional relief meet with a positive response from EU regulators.

While the regulators are not calling for a fire sale of deals that are not fully compliant with the EC's legal interpretation of the EU securitisation regulation, we expect that some Australian and other third-country issuers will begin fully to comply with the new regulations including the ESMA templates. ■

1 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, as amended.

2 https://www.eiopa.europa.eu/document-library/report/joint-committee-report-implementation-and-functioning-of-securitisation_en

3 https://www.esma.europa.eu/sites/default/files/library/jc_2021_16_esas_opinion_on_jurisdictional_scope_of_application_of_the_securitisation_regulation_003.pdf

4 *Consultation Paper – Draft Regulatory Technical Standards* (EBA/CP/2021/27), 30 June 2021, available at https://www.eba.europa.eu/eba-consults-technical-standards-risk-retention-requirements-under-securitisation-regulation and discussed in our earlier briefing: *EBA Consultation Paper on the Draft Regulatory Technical Standards relating to Risk Retention* | Perspectives and Events | Mayer Brown.

5 Directive 2003/71/EC.

6 Submission of templates for private deals to repositories is currently on a voluntary basis, but the commission stated that a requirement to register information on private deals via securitisation repositories "could be a way forward in the longer term, once the commission decides to make a proposal to amend the securitisation regulation".

7 Directive on Alternative Investment Fund Managers (2011/61/EU), Article 12(1)(b).

8 Ie small AIFMs that have a *de minimis* exemption and are only required to comply with the registration and reporting obligations of the AIFM directive (2011/61/EU).

9 HM Treasury, *Review of the Securitisation Regulation: Report and Call for Evidence Response* (December 2021), Chapter 3 (Risk retention), p23.

10 In the *Financial Services (Miscellaneous Amendments) (EU Exit)* regulations 2022.

11 Article 22(4) of the European securitisation regulation.

12 https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/reports/2022/1027593/EBA%20report%20on%20sustainable%20securitisation.pdf

13 The joint committee was due to report by 1 September 2022.

14 Regulation (EU) No 575/2013.

15 https://www.eba.europa.eu/eba-calls-european-commission-harmonise-significant-risk-transfer-assessment-securitisation

16 Article 5(1)(f) of the UK securitisation regulation.

17 See footnote 4 at p47.