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GLOBAL FINANCIAL MARKETS INSIGHT

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'Global Financial Markets Insight' is DLA Piper's Financial Markets newsletter designed to keep you informed of products, techniques and developments in the financial market.

Welcome

Change continues to be the main theme running through Summer 2014. There is the usual raft of new regulations to contend with but also welcome noises from policy makers including the European Central Bank and the Bank of England that the steps to regulate certain markets may be damaging not only to those markets but to the efforts being made to generate growth in the large global economies. With this in mind there appears to be a real effort to revitalise securitisation markets at least in those areas that are considered to meet the necessary level of clarity, transparency and stability perceived as a minimum requirement by the regulators and policy makers.

Change is also in effect at the transactional level as banks continue to deal with a difficult and uncertain regulatory environment with regard to property and consumer assets. The rate at which large banks are divesting these assets has picked up pace across Europe with Italy, Spain, Portugal, the UK and Ireland seeing big portfolio trades. This may reflect welcome increases in liquidity in the European Market and is undoubtedly influenced by Basel III, CRD IV and the current European Asset Quality Review but it may also reflect a dangerous sign of large movements out of key consumer business as more banks determine that these assets and businesses are non core resulting in reduced funding for consumers and business in the real economy.

The grand march for more reporting continues unabated on the global front as market participants across the world focus on implementing reporting regimes under EMIR and other regulatory standards. If regulators and policy makers then fail to reflect the information reported by acknowledging reduced risk where appropriate we ask if this is undermining the whole system of reporting.

We expect the final quarter to be a busy period for banks and new entrants alike.

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THE CASE FOR A BETTER FUNCTIONING SECURITISATION MARKET

If manufacturing and commerce are the engine of global economic development and growth, then finance provides the lubricant that enables that engine to function effectively. Without an effective finance market the engine will splutter forward or at worst grind to a shuddering halt.

The Bank of England (BOE) and European Central Bank (ECB) issued a Joint Discussion Paper in May 2014 on re-establishing a framework in which securitisation (and arguably banking markets generally) can function properly through the principal of adopting the concept of "Qualifying Securitisations". This paper provided some long awaited relief that central bankers, regulators and policy makers are finally looking at the numbers rather than following a populist agenda in respect of complex or not easily understood financial structures.

The steps taken to address weaknesses in the structures and regulation of complex products are already extensive and arguably more than enough to address the issues that were faced in certain products leading up to the financial crisis in 2007 onwards. The effect of these changes and a better understanding of what these products actually do from a risk perspective is essential in establishing appropriate calibration of capital to structuring, issuing and holding complex financial products. Over-regulation and punitive costs can lead to market failure just as much as under-regulation. Inappropriate pricing of capital leads to long term changes in market activity which could be difficult to remedy (we are already seeing a large number of finance providers move out of certain types of activity and large volumes of financial asset selling) which may undermine in the long term significant sources of funding and liquidity essential to certain consumer and commercial activities and the on-going health of the economy.

An effective and efficient global capital market is key to funding the needs of modern society ranging from loans to buy homes, finance cars, pay for credit items, fund education, provide infrastructure, finance commercial businesses and properties, as well as to enable our insurance companies and pension funds to model and diversify appropriate asset portfolios that will fund our retirement and healthcare. It is important that genuine efforts to make the financial system safer should not undermine the system that provides the means for effective long term economic growth and improved stability.

Securitisation has for several years provided an efficient mechanism for accessing funding by banks and others for a wide range of consumer and commercial assets. Securitisation assisted in the expansion of the global economy and efficient matching of asset and liability profiles for borrowers and investors and for the most part credit performance has been good (e.g. according to data from Standard & Poor's default rates on European RMBS outstanding in mid 2007 were only 0.12% and other asset classes had similarly low default levels compared with general corporate credit). Banks act as intermediaries between households and businesses and the financial markets that provide funding necessary for the expansion of the global economy. As with any powerful tool however, the success and flexibility of structured products enabled misuse in certain circumstances (most noticeably US sub-prime assets) and misapplication by users who were unaware of, or had sold on, the downside risks (securitisation does not remove risks in respect of assets but structures a risk/return profile in a more efficient manner). As a result losses in certain segments (e.g. sub-prime and complex CDOs) resulted in a media and regulatory backlash across all asset classes, often unfairly and for reasons based on a lack of understanding of the underlying product. Steps that are already in place to require a minimum retention of 5% of the underlying risks and increased disclosure and transparency arguably address these main structural weaknesses that effected segments of the market.

Securitisation is essentially a form of secured funding with varying degrees of credit enhancement to achieve segmented credit profiles based on statistical default and loss experience drawn on historical data. This tranching of the credit profile drives efficiency of the product as it aims to more closely match the cost of funding with structured credit profiles, and therefore risk, across a given pool of exposures. This allows a wider range of funders and users of funds to come to the market. The transfer of assets to an insolvency remote vehicle isolates the risks to the underlying exposure or pool of exposures and takes out the uncertainty of general corporate risk to enable cleaner risk analysis. The historic data may prove to be ultimately not representative but the alternative is to simply aggregate risk and take a less informed view on risk and pricing. The process does not mean that the risk disappears or even that it is necessarily accurately priced but simply that based on historic data and as analysed (typically supported by analysis from a third party rating agency) the credit profile is expected to display certain characteristics within estimated parameters.

Requiring organisations to hold more capital than is justified by the risk profile means that the efficiencies (lower pricing for the level of risk) are lost as a higher return is required to justify the capital employed. This results in funders having to look for more uncertain products (higher risk) to justify the application of capital. This is particularly problematic at a time when capital is constrained (i.e. expensive, because banks are facing higher costs, less efficiency and therefore having to pay out more to attract capital). The real cost however is borne by everyone as the cost of consumer and commercial funding is more expensive, the price mechanism is not able to work effectively, the distribution of financial assets is restricted and capital is constrained. The result is a squeeze in capital in the economy resulting in restricted growth and productivity. If banks continue to exit and capital providers such as pension funds and insurance companies cannot afford to hold securitised assets the availability of lower cost funding to consumers and companies could disappear entirely with detrimental consequences for the European and Global economy.

Recent statements by policymakers and central banks suggest a more balanced recognition of the risks and benefits of the product and importantly the significance of a well-functioning capital market including securitisation in the regeneration of an active and efficient global economy. A key element of restablishing an efficient and well functioning market however will be an appropriate callabration of risk capital that is applied to banks and other holders of securitised assets. The table on pages 6 & 7 looks at the current status and taking in the reasoning and proposals expressed in the BOE and ECB joint paper provides a road map to a better functioning securitisation market capable of assisting the smooth flow of global liquidity and acting as a catalyst for real economy growth.

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IMPORTANCE OF SECURITISATION

- Facilitates an effective mechanism for funding and risk transfer through international capital markets enabling more effective functioning of bank lending, consumer finance, commercial finance, monetary policy and financial stability.

(a) Funding

- Leads to well diversified funding (maturity, investor type, currency).
- Facilitates asset-liability maturity matching.
- Tailored to investors' risk appetite and preferences.
- Banks need it as it helps avoid build-up of systemic risk and diversifies sources of funding.
- Helps non-bank lenders raise funding for real economy lending.

(b) Risk transfer

- Subject to minimum retention requirements credit risk transfer away from the banking sector can be beneficial to the real economy, the banking sector and monetary and fiscal stability.
- Can free up bank capital (which may support the transmission of accommodative monetary policy).
- Reduces dependency on banks' lending decisions and on business cycle conditions and lowers exposure of real economy businesses to refinancing or liquidity risk thereby helping to contain systemic risk.
- May reduce concerns around banks' balance sheets reducing the extent to which funding sources are withdrawn from banks' balance sheets in times of stress.
- Contributes to issuer risk management culture through the discipline that the process of securitising assets imposes.
- Provides insurance companies, pension funds and typically long term investors with a broader pool of assets that are genuinely low risk.
- More low risk Asset Backed Securities (ABS) may increase the supply of high quality collateral which is timely given the increased focus on collateralised structures.
- Reliable secondary market liquidity enables use of ABS for effective risk management.

DETERRENTS TO FUNCTIONING MARKETS

- Regulatory capital charges for holding higher quality ABS perceived as punative/conservative compared with similar asset types.
- Solvency II proposals affecting insurance companies apply conservative treatment (even though less than previously).
- Capital charges applied by securitisation framework of Basel Committee on Banking Supervision (BCBS) have been revised downwards in recent proposals but still high.
- Investors more cautious in risk assessment due to (i) underlying assets may not have sufficient yield, (ii) complexity of product, (iii) managing risk or analysis onerous and/or (iv) regulatory compliance costs.
- A lack of standardisation across EU and between EU and US.
- Deterrents to issuing as banks constrained by uncertainty around capital relief.
- Retention requirements may act as a deterrent to non-bank issuers funding retained portions. Inconsistency of retention globally may result in unequal treatment and uncertainty.
- Certain types of asset may be difficult to securitise due to lack of data, value of cashflows or investor preferences or spreads.
- Hard sovereign rating caps undermine transparency around credit quality and negatively impact transaction structures in certain jurisdictions.
- Concerns around infrastructure required e.g. Credit Rating Agency (CRA) view on rating of swap counterparty, account bank and servicers.
- Actual or perceived illiquidity of securitisation product makes funding more expensive to issuers and less appealing to investors.

SUGGESTIONS FOR IMPROVING THE MARKET

- High level principles for qualified securitisations applied to the entire securitisation not just tranches.
- Identify securitisations that are simple, structurally robust and transparent, enabling investors to model risk with confidence and incentivising originators to behave responsibly.
- Investors still need to conduct due diligence and aim to create structures where the risks and pay offs can be consistently and predictably understood.
- Qualifying securitisations could benefit from improved secondary market liquidity and warrant regulatory capital treatment (favourable) e.g. decrease in haircuts for central bank liquidity operations.
- Benefits from harmonisation across EU and improvements in data availability.
- ECB and BOE loan level transparency requirements for ABS and SME securitisations are already a step forward. Further steps are envisaged by ESMA.
- Credit registers detailing loan performance could help. Indices could be published.
- Consideration of accounts at account banks that fall outside account banks' insolvency to avoid rating caps detriment e.g. implied ratings.

DOES SECURITISATION MEET THE FOLLOWING STANDARDS

(a) Regulatory requirements for an effective Market

Risks spread across financial systems in a transparent and diverse manner to investors that are not excessively leveraged or dependent on short term funding.

Securitised assets should embody features that improve the ability of investors to predict performance in different economic environments e.g. assets backed by real economy loans rather than re-securitisations:

- Transparent structures involving credit claims rather than derivatives (synthetic structures).
- Well understood and controlled relationships between the SPV and the Issuer.
- Authorities aware of interconnections between financial institutions.

(b) Regulatory requirements for an effective transactional product

- Underlying assets relate to credit claims or receivables with defined terms.
- Verifiable loan loss performance available for sufficient period.
- Recourse to the ultimate obligors.
- Homogenous claims consistently originated in ordinary course of business.
- Current and self-liquidating receivables.
- Security transferred with claims first ranking or all prior ranking security also transferred as part of the securitisation.
- True Sale of underlying receivables.
- Enforceable against third parties.
- Beyond reach of seller, its creditors or liquidators.
- Not effected through credit default swaps or derivatives.

STEPS ALREADY TAKEN

- Requirements for originators, sponsors or managers to retain a minimum net economic interest of 5% in securitised assets.
- An obligation on investors to have available sufficient information, and to have in place systems to carry out appropriate due diligence.
- Increased standards and requirements of good practice for banks initiating underlying business.
- Clarifying standards required to achieve significant risk transfer.
- Requirements on CRAs to be regulated.
- Requirements on CRAs to publish information relating to their rating process.
- Ability of alternative CRAs to offer unsolicited ratings.
- Requirements to obtain two rating agencies for securitisations.
- Requirements on rotation of rating agencies in relation to certain types of securitisation.
- Higher capital weightings on resecuritisation.
- Requirements on insurance companies and alternative investment funds to apply regulatory capital requirements.
- Requirements to report positions in derivatives.
- Template forms for mortgage and auto securitisation.
- Template forms to comply with industry quality standards such as PCS.
- Limits on eligibility of securitisation assets in context of liquidity requirements and money market operations.
- Changes to treatment of liquidity facilities in securitisation structures.
- Increase in capital requirement for certain securitised assets.

CONCLUSIONS

- Significant steps have already been taken to improve the workings of securitisation structures (most particularly skin in the game and transparency). This needs to be reflected in reduced NOT increased risk weightings.
- A failure to calibrate risk weightings appropriately is damaging to the ongoing effectiveness of the ABS market and could therefore undermine the future competitiveness of European businesses and harms growth in the European economy.
- Existing commentary fails to recognise that actual loss data in respect of different asset classes has been better than perceived throughout the financial crisis. Urgent action needs to be taken to:

  (i) Reduce proposed capital requirement for holding ABS assets under the Basel capital framework in-line with risk calibration of similar assets;

  (ii) Reduce proposed capital requirements for holding ABS assets under Solvency II in-line with risk calibration of similar assets.
- Announcements need to be made to clarify:

  (i) The position with regard to holding a broader range of ABS in eligible assets under the liquidity coverage ratio;

  (ii) Including ABS assets as eligible assets for purchase under ECB asset purchase regime.
- Regulators need to improve coordination of regulation, understand that there is regulatory overload and exclude regulatory overlap all of which are damaging markets.
- Policymakers need a better understanding of the role of derivatives and how they can assist the market without necessarily increasing systemic risk.
- Policymakers need to improve understanding of underlying structures and remove negative bias amongst politicians, regulators and media.
- It is all well and good to say that structures need to be simple but just like a complex piece of machinery, it is not that the machine has to be simple, it is that it needs to be properly put together and work as intended. Rules should establish that the technology works properly rather than prevent it operating at all. History has shown that the failure to utilise any significant technology presents a risk that the relevant economy will dramatically underperform.

LUXEMBOURG: A SECURED CREDITOR-FRIENDLY JURISDICTION OF CHOICE

A Luxembourg court decision of 29 January 2014 confirmed the "secured-creditor friendly" feature of the Luxembourg legal framework by (i) re-affirming that pledge agreements governed by the Luxembourg law of 5 August 2005 on financial collateral arrangements, as amended (the "Collateral Law") would survive the insolvency of the pledger, (ii) validating asymmetric jurisdiction clauses and (iii) taking the view that a maturity payment default constitutes *de facto* an enforcement event under a pledge agreement.

BACKGROUND

In 2006, a syndicate of banks granted a €2.1 billion loan to Spanish borrowers (Alteco Gestión y Promoción de Marcas, S.L., S.L. and Mag Import, S.L.) secured, *inter alia*, by a Luxembourg law governed pledge agreement over a securities account held in Luxembourg (on which the shares of the French real estate company Gecina S.A., with property holdings worth €10.7 billion in the Paris area, were credited). In October 2012, Spanish bankruptcy proceedings were opened against the two borrowers following a payment default upon maturity. At the request of the bankruptcy receiver, the Spanish court decided, in a summary judgment of 18 October 2012 (confirmed on 5 February 2013), to temporarily suspend, as a provisional and protective measure, the enforcement of the Luxembourg pledge. Secured creditors brought an action before the Luxembourg District Court to establish the validity and enforceability of their pledge, despite the Spanish judgment.

BANKRUPTCY REMOTE CHARACTER OF LUXEMBOURG PLEDGE AGREEMENTS

The Luxembourg court re-affirmed in this judgment the effectiveness of security interests granted under pledge agreements governed by the Collateral Law, by implicitly confirming that the Spanish bankruptcy proceedings opened against the two Spanish borrowers do not affect the enforcement of the pledge granted by the latter in favour of the lenders and that the Luxembourg courts are and remain competent to take any decision relating to the pledge agreement (due to the jurisdiction clause contained in the pledge agreement).

VALIDATION OF ASYMMETRIC JURISDICTION CLAUSES

The Luxembourg court also considered, for the first time, that asymmetric jurisdiction clauses (i.e. jurisdiction clauses binding one party to a specific jurisdiction and allowing the other to initiate proceedings in front of any competent court) are valid under Luxembourg law and refused to follow the Banque Edmond de Rothschild case of the French Supreme Court of 26 September 2012, which invalidated a unilateral jurisdictional clause under the Brussels Regulation by considering that this clause was to be qualified as a "one-sided" clause (*clause potestative*). It should be noted in that respect that the French decision was strongly criticised by French and European legal commentators and practitioners especially due to the application of a French legal concept in an EU regulation context.

MATURITY PAYMENT DEFAULT

The Luxembourg court further decided that, due to the accessory character of a pledge agreement (in relation to the loan agreement being secured), the non-payment of the loan at maturity constitutes *de facto* an enforcement event (even if not expressly provided in the pledge agreement) allowing the secured creditors to enforce the pledge.

The court ruled that the right to enforce a pledge in the event of non-payment at maturity is of the essence of the pledge and that any clause that would deprive the creditor of that right should be considered null and void. It remains to be seen, however, if clear and explicit contractual provisions in a pledge agreement might not somewhat alleviate the absolute right of a secured creditor to enforce the pledge upon a payment default.

CONCLUSION

This decision follows the same approach as previous case law relating to the enforcement of pledge agreements which have adopted a secured creditor-friendly approach. Luxembourg courts have affirmed in the past the robust feature of Luxembourg law governed pledge agreements and again confirmed the bankruptcy proof character of Luxembourg law governed pledge agreements.

The decision emphasises the role of Luxembourg as the largest European funds domicile and the second largest fund centre in the world after the United States. This also reaffirms the market infrastructure built up over the past twenty years supported by adequate product regulation, a modern legal infrastructure, constant innovation and a tax framework considered among the most stable and reliable in Europe.

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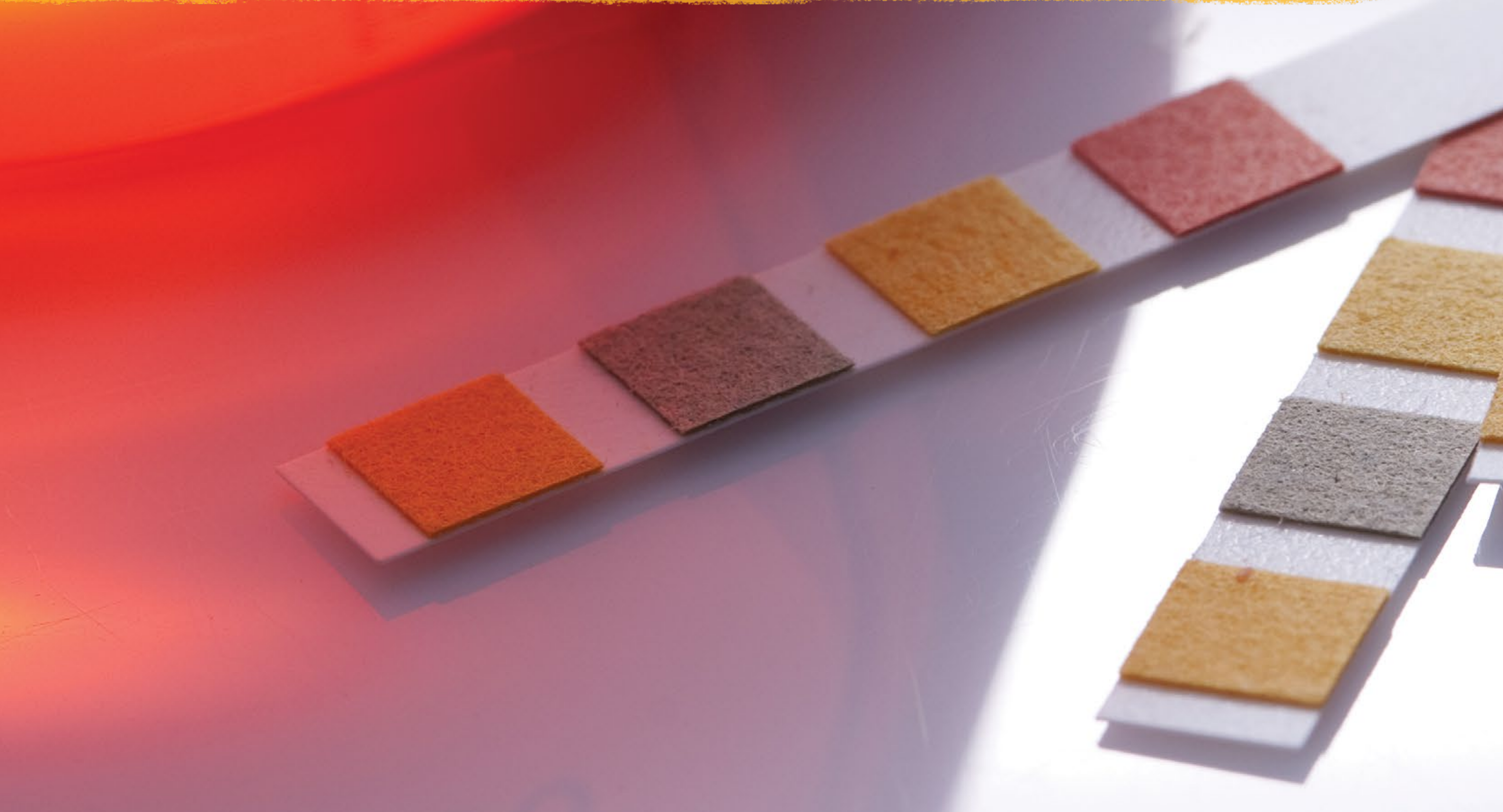
HIGH YIELD CALLING, CALL STRUCTURES BECOME A MARKET LITMUS TEST

High yield bonds continue to be the popular investment in the capital markets this year as investors seek yield in an otherwise low interest environment. According to data from S&P Leveraged Commentary and Data, July set an all-time record with 31 high yield deals in a single month. By the end of July the market in Europe hosted €63.8 billion of paper versus €47.25 billion during the same period last year, putting 2014 firmly on track to surpass 2013's full-year record supply of €70.1 billion from 211 deals.

With all this issuance, signs of over exuberance in the market were evident in July when investors started to push back on weakening call protection.



High yield bonds follow a relatively standardised and well established covenant structure. As a result, and due to the often short time frames involved the governing terms are not negotiated in the traditional sense. Rather, the managers of a deal will take a company's bonds to market with a "covenant package" that they think can be marketed to investors. Periods of intense activity in the high yield bond market tend to result in a general increase in the flexibility of covenants present in the deals being sold – investors simply don't have the time, or the coordinated bargaining power, to push back on increasingly aggressive terms.

There are certain provisions, however, that are so important to investors that resistance from the market on these terms can indicate that market fundamentals are beginning to shift towards tighter covenants. Among these is call protection – a feature of high yield bonds that investors take very seriously as the call structure will have a direct impact on an investor's potential returns.

Investors in high yield are compensated in two ways – (i) semi-annual payments of interest by way of a "coupon", and (ii) the prospect of market price upside if the issuing company improves its fundamentals or market dynamics move in favour of investors. An investor's return from the latter element is significantly influenced by the **call structure** of the bond, the **call price** being the price the issuer has to pay to repurchase the bonds.

A high yield bond issuer typically cannot repurchase its bonds until the expiration of a **non-call period** of between one and four years (depending on the maturity of the bond) unless it is willing to pay an additional amount derived from the net present value of all interest payments through the end of the non-call period. The net present value is determined by applying a discount rate based on the yield from a government reference security plus a premium (typically 50 basis points) payable in a lump sum that most issuers consider prohibitively expensive. The aim is to give investors comfort that barring default their investment will generate the agreed rate of return for at least a minimum period of time.

Following the non-call period, bonds can be repurchased at a premium calculated based on the coupon of the bond. In the first year following the non-call period the premium will be equal to the coupon such that the repurchase price will equal par plus the coupon. This will then decline rateably each year before becoming repayable at par.

From an issuer's point of view, any change to the typical non-call structure described above – whether through shorter non-call periods or cheaper bond repurchase options during the non-call period, called "soft calls" – will provide much desired flexibility to take advantage of a changing credit profile or market conditions.

Exceptions to the non-call period include a feature permitting the issuer to use proceeds of public equity offerings to repurchase up to 35% of the outstanding principal amount of bonds at par plus the coupon. The so-called "equity clawback". This allows issuers to de-lever with proceeds of publicly issued equity, which is typically seen by the market as a positive credit event.

One example of a soft call which developed during the last frothy market period allows issuers to repurchase up to 10% of the outstanding principal amount of bonds per year at a premium of only three per cent redemption price. Some versions of this provision allow the 10% amount to be measured off of the original principal amount, thereby increasing the overall percentage of the issue that can be repurchased in the non-call period.

High yield bond investors will be concerned that a bond can be called at a price lower than they are willing to pay. The issuer call price will tend to limit the price in the secondary market, and reduce liquidity of the bond issue, making it harder for an investor to trade out of the bond.

Even traditional call structures can become more issuer friendly in a busy market – call periods can become shorter than normal, or equity claw provisions are adjusted to allow issuers to use proceeds from private equity offerings in addition to public equity offerings to finance a repurchase of the bonds.

Due to the direct commercial impact of more aggressive forms of non-call provisions on the investor upside, it is one of the first places to attract investor push-back in an otherwise issuer-friendly market. For example, during late July 2014 several issuers were forced to increase the length of non-call periods set when the deal was launched or drop "soft call" provisions – or in some cases both.This string of amendments during the marketing process was followed by the announcement that one issuer – which seemingly tried to save its deal by making structural changes to the call provisions described above – had to pull its offering. Over a two week period the market became more aware of this investor push back and as a result call provisions returned to more conservative levels.

issuers have a lot to gain by attempting to adjust typical high yield call protection provisions, as flexibility around bond repurchases can make liability management much easier down the line, but the market has shown that this is one area where investors will quickly express concern if issuers push too far and for some issuers the door to the capital markets just might slam shut.

Authored by: Sabrina Fox

BRIDGING THE GAP, CAPITAL MARKETS AND EUROPEAN SME FUNDING

THE FUNDING GAP

Small to medium enterprises (SMEs) account for more than 99% of European businesses and provide over two thirds of the EC's employment. Often, these small businesses won't possess the deep pockets enjoyed by their larger corporate counterparts meaning they are dependent on flexible external funding. As highlighted in a recent BBA report, SMEs must have access to "the right finance at the right time" in order to strive ("*Financing European Growth*", July 2014).

It is unsurprising therefore, that SMEs are also the businesses which have been hit hardest by the steep reduction in bank lending available since the financial crisis. Increasing regulatory pressures mean that the funds banks have to lend are decreasing rather than rising. It seems that even state intervention, such as the UK's Funding for Lending scheme, may be unable to reverse this trend. Unfortunately, alternative investors may be unwilling to lend to SMEs due to the risks involved in lending to, or directly investing in, complex and perhaps unpredictable smaller companies.

CAPITAL MARKETS SOLUTIONS

There has been a growing focus from politicians, industry and commentators on the role which capital markets could play in bridging the SME funding gap. Some capital markets solutions could assist banks in increasing lending, whereas others could offer alternative funding streams. Three structures through which this could happen are discussed further below.

CORPORATE BONDS

Larger SMEs can access the capital markets by issuing their own corporate bonds. For smaller companies however, such investment may suffer from the same concerns as to size, stability, liquidity and transparency which investors attach to investing in SMEs directly. Moreover, the costs involved and the administration attached to issuing a bond simply isn't practical for many small businesses. Whilst mini-bonds, which have recently been recognised by FCA regulation, may offer a funding solution to some (see the highly publicised Chilango Burrito Bond, for example), it seems unlikely that such products will be able to match the sheer size of the current funding gap.

ASSET BACKED SECURITIES (ABS)

Alternatively, banks may connect SME's to capital markets through the securitisation of SME loans. By achieving significant risk transfer through securitising SME loans, banks are able to free up capital and increase future lending, generating further growth. SMEs and ABS make an intriguing political combination. SMEs are political gold dust: parties across Europe want to be seen to be backing small and mid size companies as well as the entrepreneurial spirit they embody and the employment they bring. Securitisation, however, has been stigmatised since the financial crisis, linked by some, often unfairly, with high finance and reckless banking. Recent commentators have noted however that the risks of defaults on SME securitisations are often overstated; from 2007 to mid 2012, default rates on European SME ABS were recorded to be at around 0.23%. See article "The case for a better Functioning Securitisation Market" which highlights recognition of the role which securitisation can play in a modern European economy.

There will still be difficulty however, in attracting wary investors, particularly from pension funds or other risk adverse institutions, to invest in SME ABS. Mitigation of these concerns is being achieved through the development of banks providing guarantees to mezzanine or senior tranches of SME ABS. Doing so allows the rating of the relevant notes to benefit from the development bank's rating (which may be AAA), as well as the positive market publicity that the guarantor's involvement will bring. The EIB Group (a collaboration between the European Investment Bank and European Investment Fund), launched the "EIB Group ABS initiative for SMEs" in 2012, which was intended to "restart the SME securitisation market" by both investing in, and guaranteeing, SME ABS. Similar schemes also exist at a national level (see for instance the FTPYME scheme in Spain). Time will tell if a sufficiently larger liquid and robust market will develop without the need for such reliance.

SME COVERED BONDS

Perhaps the most interesting option lies in the emerging SME covered bond structure. Under EU Capital Requirement Regulations (as well as the laws of most member states) covered bonds may only be backed by assets such as residential mortgage loans, debts to public sector entities or shipping loans. Accordingly, in all but a small minority of EU states, SME loans cannot constitute covered bond collateral. Despite this, low levels of demand for SME securitisation has stirred interest in SME covered bonds.

In February 2013 Commerzbank issued a hybrid covered bond, backed by SME loans. The Commerzbank bond possessed the key characteristics of a covered bond; being directly issued by Commerzbank and guaranteed by an SPV holding assets and thus offering dual recourse to investors, as well as being heavily over-collateralised. The bond is not recognised by German covered bond law, but was rated by Fitch under their covered bond criteria. A key feature of Fitch's decision to rate the bond, lies in the bond's pass-through mechanism. This mechanism means that upon an Issuer event of default occurring, the covered bond company will not be forced to sell the asset pool in order to try and release immediate value. Instead, the proceeds of the assets pass straight to bondholders as they materialise, even if this means principal is still being paid to bondholders after the intended maturity date of the bonds. SME loans, compared with mortgages, lack liquidity, and are likely to suffer heavy discounts in the event of forced sale, thus meaning bondholders are unlikely to recover their principal. Whilst some may dislike the removal of the certainty associated with the covered bond bullet maturity, the increased likelihood of investors receiving their capital cannot be ignored.

We have also seen in markets such as Turkey, which began recognising SME covered bonds in 2007, a number of successful issues.

It is likely however that the potential impact of SME covered bonds, at least, in the short-term is limited. SME covered bonds are not recognised by the law of most states and there is doubt over whether market trends will rally behind products not recognised by national or European law.

SUMMARY

At this point in time however, no single solution appears to offer a full construct, with each missing various bricks. A common theme seems to be regulation and legislation. Whilst politicians have begun to acknowledge that the capital markets can offer much to SMEs, such acknowledgement must be backed by regulatory commitment. An appropriate regulatory capital framework based on a better understanding by regulating of the various products needs to be established. Perhaps then, with the final regulatory brick in place investor confidence will grow and SMEs will have access to the funds they require.

Authored by: Tim Finlay

DISCLOSURE,
IS IT WORTH TRYING TO PLEASE EVERYONE?

If there was ever any doubt as to the aspirations of the European Parliament, the European Commission, the European Banking Authority, the European Securities and Markets Authority (ESMA), the European Central Bank (ECB), the Bank of England and, to a certain extent, certain market participants with regard to disclosure in securitisations one only has to look at some of the major initiatives of the past five years in the securitisation area to see that enhanced disclosure has been a priority.

The reasons for more disclosure have been expressed in a number of ways: (i) enhanced disclosure will allow investors to receive sufficient information on the quality and performance of their underlying assets with a view to enabling them to perform informed assessment of the creditworthiness of the instruments they are buying[1], (ii) prospective investors should have readily available access to all materially relevant data as well as such information that is necessary to conduct comprehensive and well informed stress tests on the cash flows and collateral values supporting the underlying exposures[2], (iii) transparency, amongst other virtues such as quality, simplicity and liquidity will result in sustainable funding tools for investors resulting in improved market resilience and growth in the real economy[3], (iv) that additional data requirements will help both investors and third-party assessment providers with their due diligence leading to restored confidence in the securitisation market[4] or (v) that enhanced transparency will enable investors to model risk with confidence and provide originators with incentives to behave responsibly[5].

It is said that wisdom and prudence are always recompensed[6] but the question remains whether the prudent (and some would argue onerous and at times intrusive) disclosure requirements are being applied with any wisdom. Regulations such as the CRR[7], the CRA3[8] and initiatives such as the Prime Collateralised Securities (PCS) label, the ABS Loan-level initiative of the European Central Bank, the requirements of the Bank of England in order to qualify for the discount window facility and be eligible for collateral in the Bank of England's operations and possibly in the future be considered as "qualifying securitisations" appear to be generated without any care as to mutual consistency or process of reporting. More worryingly the capital and regulatory treatment does not itself take note of or apply the risk analysis that is being provided through the reporting standards.

LOAN LEVEL INFORMATION

Providing and updating loan level information is not a small undertaking particularly when you have a portfolio of hundreds if not thousands of assets. When you have diverging requirements relating to that loan level information it is even more challenging. The RTS[9] in relation to the CRR requires information to be provided on a loan-by-loan basis but recognises that there are instances where the data may be provided on an aggregate basis depending on things such as the granularity of the underlying pool and whether the management of the exposures in that pool is based on the pool itself or on a loan-by-loan basis. CRA3 requires that where a structured finance instrument is backed by residential mortgages, commercial mortgages, loans to small and medium sized enterprises, auto-loans, consumer loans, credit card-loans and leases to individuals and/or businesses, the reporting entity shall provide loan level information through the standardised disclosure template relating to such asset classes. The PCS Simplicity Standards require that prior to an issue, the Issuer or originator will make available (i) for underlying assets which are not granular assets, loan-level

1 Regulation EC 1060/2009 on credit rating agencies

2 Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms

3 The PCS Mission

4 European Central Bank – ABS Loan-level initiative

5 The case for a better functioning securitisation market in the European Union – May 2014 – The Bank of England and the European Central bank

6 *Comtesse de Ségur*, Old French Fairy Tales

7 Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms

8 Regulation EC 1060/2009 on credit rating agencies

9 Commission Delegated Regulation (EU) No 625/2014 of 13 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council by way of regulatory technical standards specifying the requirements for investor, sponsor, original lenders and originator institutions relating to exposures to transferred credit risk

data to enable investors or third party contractors to build a cash flow model setting out the transaction cash flows or, (ii) in relation to underlying assets which are granular assets, detailed summary statistics on the underlying assets; and on or about the date of issue and thereafter, it will make available data on underlying assets in a data repository that complies with the requirements of a) the Bank of England concerning data disclosure for eligibility to its repo programs, or b) the European Data Warehouse (ED) or c) another publicly available electronic depository that is approved and published by PCS. The Bank of England requires loan level information to be made publicly available at a frequency of not less than quarterly and within a defined period after the relevant bond payment date for the following assets classes: RMBS, covered bonds, CMBS, CLOs, and securitisations of auto, consumer, lease and private student loans[10] in each case based on the relevant template for such asset class. The "qualifying securitisation" initiative suggests that sufficient loan-level or granular pool stratification data should be made available at the time of securitisation to potential investors in order to permit construction and analysis of cash flow models. Information should then be provided on an ongoing basis with updated loan-level performance data and standardised investor reports to current and potential investors on a monthly/quarterly basis throughout the life of the securitisation. The ECB ABS loan-level initiative has its specific loan-by-loan information requirements for ABS that can be accepted as collateral in the Eurosystem credit operations as well as prescribing the templates required for each relevant asset class. Uploading this data was supported by the creation of the ED in June 2012. The ED is now fully operational and provides a central portal where investors, originators and rating agencies can access data.

AND THERE'S MORE

Aside from the demands of the loan-level disclosure discussed above, the RTS provides further that originators, sponsors and original lenders shall ensure that materially relevant data is readily accessible to investors, without excessive administrative burden, the scope of what is materially relevant could potentially go beyond loan-level information. CRA3 also requires that, *inter alia*, the final offering document, the closing transaction documents, the asset sale agreement, servicing agreements; inter-creditor agreements, swap documentation, loan agreements, liquidity facility agreements and any other relevant underlying documentation must be disclosed, bear in mind that CRA3 continues to apply to private unrated transactions. The Bank of England also requires, *inter alia*, transaction documents, a transaction summary and a cashflow model to be made freely and publicly available. And the lists go on!

HURDLES

As can be seen a party hoping to have a compliant securitisation with a PCS label that could potentially be a "qualifying securitisation" and be eligible for operations with the Bank of England and the ECB would have several hurdles to jump. Although there is overlap between many of the requirements in the regulations and initiatives it is accepted that there is not a one size fits all. The templates required by CRA3, the Bank of England and the ECB although similar are not identical. In addition the requisite templates need to be uploaded to the Bank of England, the ED and under CRA3, a website set up by ESMA separately. In the case of CRA3, which continues to apply to private unrated transactions, the ESMA website represents a very public forum for sensitive information. All these factors lead to higher administrative costs and reduced enthusiasm.

QUID PRO QUO?

Perhaps the major stumbling block with such onerous disclosure is that it is not clear to many what the tangible benefits are. Securitisation still struggles to be recognised as a High Quality Liquidity Asset for the purposes of the Liquidity Coverage Ratio and continues to be discriminated against for the purposes of calculating risk weights with proposed capital requirements for securitisation exposures much higher than justified by historical losses. The PCS label does not automatically qualify a securitisation for any preferential treatment (although there is no doubt that it is a step in the right direction) and although operations at the Bank of England and the ECB provide liquidity, these really only promote the use of the AAA tranche as a funding tool and are subjected to haircuts. Finally the CRR and CRA3 rather than providing any incentives rely more on the threat of penalties for non-compliance. It is hardly surprising that securitisation in 2013 stood at €174 billion, only 40 per cent of pre-crisis issuance[11].

What is really needed is a disclosure standard that is widely accepted across all initiatives and regulations and information that can be posted to a single central location, making the disclosure process less onerous and more streamlined enabling those who are contemplating a securitisation transaction to see the potential rewards for their efforts.

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[10] Bank of England website: http://www.bankofengland.co.uk/markets/Documents/marketnotice100719a.pdf

[11] The case for a better functioning securitisation market in the European Union – May 2014 – The Bank of England and the European Central bank

AUSTRALIA'S CHANGING OTC DERIVATIVES TRANSACTION REPORTING LANDSCAPE

BACKGROUND

In 2009 at the G20 Summit in Pittsburgh the G20 members, including Australia, committed to significant reforms relating to the OTC derivatives market. The proposed reforms addressed risks inherent in the OTC derivatives market, with aims to improve market transparency, efficiency, risk management and integrity. A key commitment made by the G20 members at the G20 Pittsburgh Summit was for all OTC derivatives transactions to be reported to trade repositories.

We briefly discussed this key commitment from a European reform perspective in Issue 1, Q4 2013, and in that issue we also commented on the proposed European timetable for mandatory reporting to trade repositories.

The Financial Stability Board (FSB) recently reported that as at the end of Q1 2014, 15 of the total number of FSB member jurisdictions (which include the G20 major economies and more specifically Australia) had trade reporting requirements partially, if not fully, in effect.

Below is a summary of the progress that has been made in Australia towards implementing a framework for mandatory reporting of derivatives transactions to trade repositories.

LEGISLATIVE FRAMEWORK

Effective from January 2013, a new Part 7.5A (*Regulation of Derivative Transactions and Derivative Trade Repositories*) was inserted into the *Corporations Act 2001* (Cth). This amendment empowered the relevant Minister to prescribe certain classes of derivatives to be subject to the rule-making power of the Australian Securities and Investments Commission[1] (ASIC) in respect of various matters including mandatory transaction reporting to trade repositories.

In May 2013, the Minister made a determination as to the classes of OTC derivatives that will be subject to the mandatory reporting obligation, namely: commodity derivatives[2], credit derivatives, equity derivatives, foreign exchange derivatives and interest rate derivatives.

Following the establishment of the legislative framework, ASIC introduced *the ASIC Derivative Transaction Rules (Reporting) 2013* (the Rules) together with the *ASIC Derivative Trade Repository Rules 2013*. The Rules set out the type of derivatives transactions information and position information that a Reporting Entity[3] is required to report to a trade repository.

Phases 1 and 2

The Rules also outline a new reporting regime that is in the process of being implemented via an "opt-in" mechanism in conjunction with a three phase process. Under the "opt-in" mechanism, financial entities are able to elect to become subject to the mandatory reporting requirements at an earlier time than as otherwise prescribed by the Rules.

For those Reporting Entities that do not opt-in at an earlier time, the three phase implementation process dictates when the mandatory reporting requirements become applicable to those entities. The mandatory reporting obligations commenced in October 2013 for Phase 1 Reporting Entities (namely Australian entities registered as US Commodity Futures Trading Commission swap dealers) and in April 2014 for Phase 2 Reporting Entities (namely certain major financial institutions with gross notional outstanding positions of more than AUD $50 billion as at 30 December 2013).

Phase 3

The onset of Phase 3 of the new reporting regime is now imminent. Phase 3 will affect Reporting Entities that are Australian ADIs, Australian Finance Services Licensees or certain other foreign financial entities which should have been captured under Phases 1 or 2 but were not (for example, because their notional positions were less than AUD $50 billion as at 30 December 2013).

Initially the mandatory reporting obligations for Phase 3 Reporting Entities were to commence on 1 October 2014. However a recent class order exemption by ASIC has provided for a delayed and staggered start for mandatory reporting by Phase 3 Reporting Entities.

Pursuant to the class order exemption, Phase 3 Reporting Entities have been split into two categories – Phase 3A Reporting Entities and Phase 3B Reporting Entities.

For Phase 3A Reporting Entities (namely Phase 3 Reporting Entities with total gross notional positions of AUD $5 billion or more as at 30 June 2014) the reporting obligations are now to commence on 13 April 2015 or, if ASIC grants the first licence to a trade repository after 13 October 2014, then seven months after that licensing date.

For Phase 3B Reporting Entities (namely Phase 3 Reporting Entities with total gross notional positions of less than AUD $5 billion as at 30 June 2014) the reporting obligations are now to commence on the earlier date of 12 October 2015 or 13 months after the licensing date (as described above).

MOVING FORWARD

Despite the delayed commencement of Phase 3, Phase 3 Reporting Entities should continue working towards ensuring that they have the required systems and processes in place to equip them to achieve compliance with the Rules and mandatory reporting obligations.

On a general note, Australia's continued commitment to the OTC derivatives market reforms is evident from the progress made to date, particularly with respect to the recent developments in its OTC derivatives transaction reporting landscape. The timing of such progress however remains dependent on, and reflective of, limitations which participants have encountered in preparing for compliance with those reforms.

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[1] Australia's corporate, markets and financial services regulator.

[2] Interestingly, electricity derivatives are currently carved out from the application of these reporting requirements following objection from certain key players in that market. This carve-out remains subject to review.

[3] A **"Reporting Entity"** is defined in the Rules to include certain: Australian entities; foreign subsidiaries of an Australian entity that is an authorised deposit taking institution (**"ADI"**) or Australian Financial Services Licensee; a foreign ADI that has an Australian branch, and a foreign company that is registered under Part 5B.2 of the *Corporations Act 2001* (Cth).

EMIR

THE NEXT STAGE OF ISDA REPORTING REQUIREMENTS

On the heels of the initial reporting requirements under Article 9 of EMIR and the ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol, the next stage of reporting requirements has come into effect. As of 11 August 2014 (180 days after the start of the 12 February 2014 reporting obligations) EMIR now requires valuation and collateral reports for all outstanding derivative positions and collateral posted.

WHAT DOES THE REPORT REQUIRE?

The report must include the mark to market value of OTC or exchange traded derivatives (ETDs), if the trade is collateralised, as well as the value of the collateral. Valuations must be reported both by the dealer and the client at the end of the day following the execution of the contract. Collateral valuations must be reported by the end of the day following the valuation date by the trade party posting collateral. For ETDs and cleared trades, valuations must be reported by the clearing house (CCP), clearing broker and the client to a Trade Repository (TR) that is monitored and regulated by ESMA in accordance with Article 55 of EMIR or a non-EU trade repository recognized in accordance with Article 77 of EMIR.

WHO IS AFFECTED?

It is important to understand your status under EMIR in order to decide whether or not to adhere to the Protocol. Although reference to "counterparties" initially caused some confusion, ESMA clarified the position: the reporting requirement applies only to FCs and NFCs. FCs, or financial counterparties, are entities subject to certain EU legislation, such as banks, investment firms, insurance companies, pension funds, UCITS funds and alternative investment funds managed by fund managers authorized under AIMFD.

The level of reporting by NFCs, or non-financial counterparties, under EMIR depends on the volume of OTC derivatives trading activity in which they are engaged. If above a certain level, they are called NFC+s, and if below this level, NFC-s, which do not bear the same reporting requirements. This could include large corporations or investment funds established in the EU but managed by a US manager. Note that once such funds (or funds established outside the EU) are managed by EU AIFMs authorised or registered under the AIFMD, then they will be considered FCs and thereby subject to more stringent regulatory reporting requirements.[1]

WHAT AGREEMENTS ARE COVERED?

According to the ISDA/EMIR guidance notes, the reporting obligation applies to derivative contracts which:

(a) Were entered into before 16 August 2012 and remained outstanding on that date: or

(b) Are entered into on or after 16 August 2012.[2]

The Protocol does not relate solely to ISDA Master Agreements and includes ISDAs that have been executed between two adhering parties prior to the implementation start date, as well as to "deemed" ISDA master agreements that have arisen by adhering parties executing (again, prior to the implementation date) any long-form confirmation entered into before or after implementation. As well as any pre-implementation executed ISDA Master Agreement and any pre-implementation date umbrella agreement signed by an agent.[3] The ISDA Master Agreements covered by the Protocol are called "Covered Master Agreements".[4]

CAN I USE A DELEGATE?

Reporting may be done directly or through the use of counterparties by delegation. Market participants using delegated reporting services are obliged to provide any counterparty data required in order to facilitate the reporting delegate's compliance with its obligations. These counterparties are required to report the details of any derivative contract they have concluded and any modification or termination of the contract to a registered or recognised trade repository.

WHAT IF INCORRECT OR MISLEADING INFORMATION IS PROVIDED?

If there has been a proven misrepresentation, with the result that an OTC derivative contract subject to these regulations has not been cleared or the prescribed mitigation procedures have not been applied, while this may not constitute a default, parties are subject to additional mitigation requirements. If these procedures are not adhered to, either party may terminate the relevant OTC derivative contract. In either case, a balancing payment may be payable.[5]

It is important to note that clearing obligations for NFC+s ("systemically important" non-financial counterparties) will begin in 2015. Collateral exchange requirements will also be phased in in 2015.

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[1] See http://www2.isda.org/functional-areas/protocol-management/faq/11/

[2] EMIR Reporting Guidance Note, July 19, 2013. http://www2.isda.org/emir/

[3] See: http://www2.isda.org/functional-areas/protocol-management/faq/15

[4] See ISDA 2013 EMIR NFC Representation Protocol, 8 March 2013, http://assets.isda.org/media/ac6b533f/30fa0eeb.pdf/

[5] See *Portfolio Reconciliation*: http://www2.isda.org/functional-areas/protocol-management/faq/15

WHAT PRICE CAPITAL?
THE COST OF HOLDING ABS

The proposed capital charges under the Basel III and Solvency II regimes are detailed and complex, and subject to on-going consultation (and recalibration) by the mandated regulatory agencies. The purpose of this article, therefore, is to highlight the current status of proposed capital charges under the two regulatory regimes. Such capital charges (even after some element of softening) are generally considered within the ABS industry as being prohibitively conservative, potentially make the holding of ABS uneconomical and deterring investors (i.e. banks under Basel III and insurers and pension funds under Solvency II) from holding such assets.

We will look at three areas in which the capital cost of holding ABS, if implemented as currently proposed under Basel III or Solvency II (as applicable), is likely to have a profound impact on the ABS industry.

(1) Capital costs of holding ABS under Basel III

The table below shows the proposed risk weightings to be ascribed to securitisation positions under the Basel Committee Consultation Paper entitled "Revisions to the Securitisation Framework" of December 2013. The table shows that capital costs of holding securitisation assets can generally be expected to increase (substantially) as a result of implementation of Basel III, particularly in the case of highly rated, short term assets. The Basel Committee did make a move towards less prohibitive capital costs for such assets under the second consultation documents but positions remain significantly above the capital requirements imposed under Basel II for highly rated securities.

Rating	**Risk weightings under second consultative document**		**Risk weightings under first consultative document**		**Risk weightings under Basel II securitisation framework**	
	Maturity		**Maturity**		**Maturity**	
	1 year	*5 years*	*1 year*	*5 years*	*1 year*	*5 years*
AAA	15%	25%	20%	58%	7%	7%
AA+	15%	35%	32%	75%	8%	8%
AA	25%	50%	51%	97%	8%	8%
AA–	30%	55%	61%	110%	8%	8%
A+	40%	65%	71%	124%	10%	10%
A	50%	75%	81%	141%	12%	12%
A–	60%	90%	94%	162%	20%	20%
BBB+	75%	110%	106%	183%	35%	35%
BBB	90%	130%	118%	203%	60%	60%
BBB–	120%	170%	136%	235%	100%	100%
BB+	140%	200%	153%	265%	250%	250%
BB	160%	230%	170%	294%	425%	425%
BB–	200%	290%	210%	363%	650%	650%
B+	250%	360%	262%	442%	1,250%	1,250%
B	310%	420%	321%	485%	1,250%	1,250%
B–	380%	440%	389%	502%	1,250%	1,250%
CCC [+/–]	460%	530%	472%	568%	1,250%	1,250%
Below CCC–	1,250%	1,250%	1,250%	1,250%	1,250%	1,250%

The Basel Committee has attributed the proposed increase in capital costs to (among other things) the poor performance of highly rated securitisation assets (albeit over a relatively short time period). More specifically, the Basel Committee cited the following factors in concluding that risk weights under the existing securitisation framework are insufficient:

(i) A misplaced assumption that credit losses of securitised assets were less correlated with specific global risk factors than similar assets retained by the relevant financial institution. The Basel Committee believe that questions can be raised regarding the previously-perceived benefits of diversification that securitisations were expected to provide.

(ii) A failure to adequately allow for maturity risks. In addition, the Basel Committee believe that the current system does not adequately address tranche thickness or type.

(iii) Other questionable modelling assumptions.

Finally, it is interesting to note that the Basel Committee consider existing risk weights for lower rated securitisations to be too high, and has proposed decreases as a result.

(2) Capital costs of holding ABS under Solvency II

The table below shows the capital charges proposed by EIOPA (the European Insurance and Occupational Pensions Authority) pursuant to the "Technical Report on Standard Formula Design and Calibration for Certain Long-Term Investments" of December 2013, and the "Technical Specification for the Preparatory Phase" of April 2014. The papers serve as a recommendation for the European Commission for the purposes of implementing Solvency II.

Rating	AAA	AA	A	BBB	BB	B	CCC or lower
'Type 1' capital charge for securities with 1 year duration[1]	4.30%	8.45%	14.80%	17-20%	82 %	100%	100%
'Type 2' capital charge for securities with 1 year duration	12.50%	13.40%	16.60%	19.70%	82 %	100%	100%

The Report makes a distinction between 'Type 1' and 'Type 2' securitisations[2],and it is easy to see from the above table the capital cost implications for the distinction. The criteria for Type 1 securitisations are extensive, and just a few of these are listed below for illustration:

- The securitisation must be listed in a regulated market in an European Economic Area or Organisation for Economic Co-operation and Development country.
- The relevant tranche must be unsubordinated on enforcement/acceleration.
- The underlying assets should be held by a special purpose entity on a solvency remote basis.
- The underlying assets should be either RMBS, SME loans, auto-loans, property leases, credit card receivables or other consumer loans (this helpful includes most types of ABS).
- Of particular consternation for the ABS industry is the stark comparison to the proposed capital charges for corporate bonds having equivalent credit worthiness, as highlighted in the table below:

Rating	AAA	AA	A	BBB	BB	B	CCC or lower
Capital charge for securities with 1 year duration	0.9%	1.1%	1.4%	2.5%	4.5%	7.5%	7.5%

At the time of writing, it is expected that the European Commission will shortly announce a reduction in the proposed capital charges for ABS. In the case of Type 1 securitisations rated BBB or higher, capital charges are expected to be halved. However, disparity with the treatment of corporate bonds is likely to continue to be a cause of some frustration.

(3) The Liquidity Coverage Ratio under Basel III

Basel III introduced for the first time the Liquidity Coverage Ratio or "LCR". Put simply, the Liquidity Coverage Ratio requires that banks maintain sufficient "high-quality liquid assets" to survive a significant stress scenario lasting for a period of one month. The idea is that, under such conditions,

1 In all cases, for securities with a duration of more than one year, EIOPA specifies a 'spread risk' that applies in order to increase the relevant capital charge as the duration of the instrument (and therefore exposure) increases.

2 It is understood that the clear distinction between 'Type A' securitisation and high-quality liquid securitisation was by design.

the bank in question would hold sufficient liquid assets (i.e. assets that could be immediately turned into cash for equivalent or close-to-equivalent value) in order to survive a hypothetical stress scenario.

The European Banking Authority (EBA) has been mandated to develop the concept of high-quality liquid assets, and in this regard distinguishes between assets of "extremely high" and "high" liquidity and credit quality. In its report of December 2013, the EBA determined which assets would be considered to be of "extremely high" or even "high" liquidity or credit quality, and which assets would be deemed to be of insufficient liquidity – see below:

Assets deemed to be of "extremely high liquidity and credit quality"[3]	**Assets deemed to be of "high liquidity and credit quality"[4]**	**Assets deemed by the EBA to be of insufficient liquidity**
EEA sovereign bonds, minimum issue size of €250 million	EEA sovereign bonds, minimum issue size of €100 million	Equities
EEA covered bonds, minimum issue size of €500 million	EEA covered bonds, minimum issue size of €250 million	Gold
	Corporate bonds, minimum issue size of €250 million, mature within 10 years	ABS not backed by residential mortgages
	RMBS, minimum issue size of €100 million, mature within 5 years	Credit claims
	Supranational bonds, minimum issue size of €250 million	Securities issues by financial institutions
	Local government bonds, minimum issue size of €250 million, mature within 10 years	Central bank securities
		Bank-issued government guaranteed bonds
		Bonds issued by promotional banks

[3] All assets in this column are also expected to be rated AA- or higher by S&P/Fitch and Aa3 of higher by Moody's

[4] All assets in this column are also expected to be rated AA- or higher by S&P/Fitch and Aa3 of higher by Moody's, except for corporate bonds which must be BB-/Ba3 of higher and sovereign/local government bonds which must be A-/A3 of higher.

The EBA specify further conditions in order for RMBS to qualify as high liquidity assets. These include the conditions that the underlying residential mortgages must be first-lien, only senior tranches may be included, and other conditions relating to maturity and prepayment rate. A 25% haircut would also apply to RMBS when calculating the contribution to total stock of high-quality liquid assets. Finally, the combination of RMBS and lower-rated corporate securities (known under Basel as 'level 2B assets') may only account in aggregate for 15% of the total high-quality liquid asset holding needed to comply with the LCR.

The findings of the EBA can be viewed in both a positive and negative light. There is an acknowledgement of RMBS as high-quality liquid assets (notwithstanding the additional conditions, haircuts and limited contribution) which is an indication that regulators may be more willing to recognise ABS assets as equivalent to other securities having a similar credit rating for regulatory capital purposes, however the failure to include other highly rated ABS assets even if widely traded limits the likely liquidity and attractiveness of this product in the future.

Conclusion

The higher capital weightings applied to ABS highly rated tranches and the lack of recognition of high credit quality and liquid tranches of ABS for LCR purposes are both likely to cause difficulty in the development of an active and effective market in high grade ABS. Both measures limit the range of assets that can be held by banks and insurance companies on an on-going basis, thereby increasing systemic risk and both measures further limit the availability of funding to businesses and consumers as banks reduce lending that cannot be securitised to meet balance sheet constraints.

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THE ECB'S OUTRIGHT PURCHASE OF **ABS ANNOUNCED**

On 4th September Mario Draghi announced that the Eurosystem will go ahead with purchases of certain simple and transparent Asset Backed Securities (ABS). The announcement comes more than two months after the European Central Bank (ECB) unveiled plans for its outright purchase of ABS but the detail remains elusive. Mr Draghi confirmed that the details relating to the proposals will be set out after the Governing Council meeting on 2nd October 2014 and will be based on the preparatory work previously described as being "intensified". It was also reputed that Blackrock has been approached to act as asset manager. It is also proposed that the Eurosystem would start a euro area covered bond purchase programme again with details to follow. There remains however significant issues with regard to the success of implementation of the programme, not least due to the ECB's own contradictory policies. This article outlines some of the policies employed by the ECB to kick-start the European economy and explores the ECB's rationale for supporting a revival of the ABS market.

UNCONVENTIONAL REFORMS

On 5th June 2014, the ECB announced a package of measures that it hoped would support lending to the real economy and in doing so spur European economic growth. Some of the key measures included:

i) The introduction of a series of targeted long-term refinancing operations (TLTROs) aimed at encouraging bank lending to euro area households and non-financial corporations over a four-year period[1]. Similar to the Bank of England's Funding for Lending scheme (although focussed primarily on lending to businesses rather than households), TLTROs allow participants to refinance eligible lending by borrowing money from the ECB[2] at low fixed-rates[3];

ii) Decreasing the rate that the ECB pays to banks on overnight deposits to a negative rate of -0.1%. Effectively this results in a charge on excess reserves and penalises banks for not lending their deposits into the economy; and

iii) The "intensification" of preparatory work relating to the outright purchase of ABS.

ECONOMIC BACKDROP

The Eurozone economy is recovering slower than was forecast. In Q1 2014, the Eurozone economy was more than 2% smaller than in 2008 and year-on-year growth stood at just 0.2%.[4] This was even before Russia's economic sanctions on the Ukraine started to take effect.

By July, Eurozone inflation had also fallen to 0.4% on an annualised basis – the tenth consecutive month of sub-1% inflation, the level perceived by the ECB as creating a risk of deflation. A deflationary environment would exacerbate existing problems as it typically leads to an economic slow-down or contraction as people postpone spending, incur less debt and prices and wages fall.

Euro area annual inflation and its main components, August 2012 to July 2014[5]

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[1] *It is estimated that if banks were to take advantage of the full allotment, the TLTROs could expand the ECB balance sheet by 20%. Refer to the article, "ECB Measures to Boost Bond Performance, Not Growth" at http://www.economonitor.com/blog/2014/06/ecb-measures-to-boost-bond-performance-not-growth/#idc-container.*

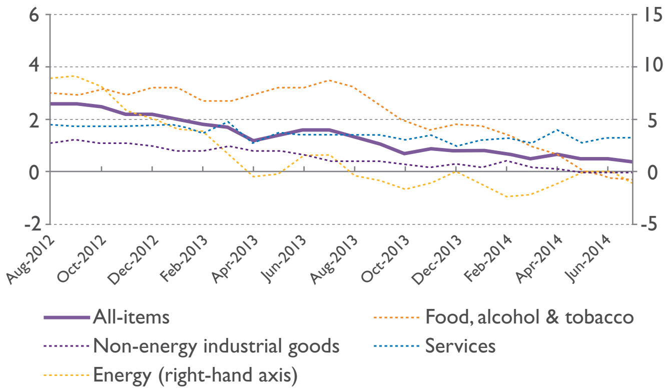
[2] *The ECB will initially finance up to 7% of a bank's outstanding loans to households (excluding mortgages) and businesses (totalling around €400bn) with further advances up until April 2016 according to net lending figures.*

[3] *On current rates, interest on the TLTROs will be charged at 0.25% (being the interest rate on the main refinancing operations of the Eurosystem of 0.15% plus 10 bps). Principal and interest will be paid bullet at maturity.*

[4] *Refer to the article, "ECB Measures to Boost Bond Performance, Not Growth" at http://www.economonitor.com/blog/2014/06/ecb-measures-to-boost-bond-performance-not-growth/#idc-container.*

RECOGNISING THE NEED FOR REVIVAL

Against this backdrop the importance of reviving the ABS market is now recognised by the ECB. ***"There is growing consensus that an instrument once seen as part of the problem could in fact be part of the solution",*** said Yves Mersch, Member of the Executive Board of the ECB during his keynote speech at the ABS Conference in Barcelona.[6] From the ECB's perspective, a well-functioning European ABS market is central to its long term objectives of price stability, financial stability and the stability of its own balance sheet[7].



To date, the ECB's direct support for the European ABS market has involved accepting certain ABS as eligible collateral for its intra-day Eurosystem credit operations. However, only certain meeting high credit and disclosure standards and denominated in US dollars, Japanese yen, pound Sterling or Euro are currently eligible. Although details of the proposed purchase programme are scant at present, the scheme will involve the outright purchase of claims against the Euro area non-financial private sector under an ABS purchase programme (ABSPP). In parallel the Eurosystem will also purchase a broad portfolio of euro denominated covered bonds issued by MFIs domiciled in the Euro area. Detailed modalities will be announced after the Governing Council meeting at the beginning of October as a means of generating liquidity in the market.

Like many of the policy initiatives launched since the financial crisis it is not clear that the programme would have the result the ECB intends and may be neutralised by other initiatives already in place or proposed. The availability of an estimated €450-€850 billion of cheap credit to banks from September through the TLTROs, for example may make other funding techniques like securitisation less attractive further impeding the development of liquidity in that market.

As well as potentially hampering ABS activity, the TLTROs seem likely to miss the intended objective of spurring lending to the real economy. Whilst cash will be made available to banks and availability tracks net lending to euro area households and non-financial corporations, the TLTRO framework does not stop participating banks from using the fungible proceeds to buy government debt (attractive from a capital adequacy perspective) or repay existing LTRO loans that mature in February 2015[8] – both of which are less risky than lending to SMEs. The only penalty is a requirement to repay the TLTRO loans two years earlier – by September 2016 rather than the scheduled repayment in September 2018. Rather than filtering down to the real economy, counterparties are likely to use the allocations for yield enhancement by investing in government bonds.

OTHER INITIATIVES UNDER REVIEW

The European Commission has been holding informal discussions with member states and stakeholders regarding the expansion of the range of ABS assets eligible for inclusion in reaching banks requirements under the liquidity coverage ratio (LCR). This would involve the inclusion in the LCR of ABS backed by auto, SME and consumer loans. Under the LCR to be implemented in 2015, financial institutions are required to hold sufficient "high quality liquid assets" (HQLA) at any time to meet their liquidity requirements over the following 30 days. Including a wider range of ABS to count towards Level 2B buffers which would certainly represent a step in the right direction.

Further changes to capital and liquidity requirements for ABS are still under consideration (with a final decision on the LCR delayed until September).

THE NEED TO REVIVE THE ABS MARKET

In Europe, aggregate issuance has been notably lower since the crisis with only €174 billion issued in 2013, equivalent to roughly 40% of the pre-crisis annual rate. Only a few asset classes have bucked the trend such as auto loans and consumer loans.[9]

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[5] *Data taken from: http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/File:Euro_area_annual_inflation_and_its_main_components_(%25),_August_2012_-_July_2014-p.png.*

[6] *Refer to the transcript which is available at: http://www.ecb.europa.eu/press/key/date/2014/html/sp140611_1.en.html.*

[7] *For more information on the reasoning behind the support expressed by the ECB and Bank of England for an effective ABS market see "The case for an effective securitisation market" earlier in this magazine.*

[8] *Existing LTRO facilities cost 0.65 per cent at current rates.*

[9] *Refer to the article, "The UK Auto Securitisation Market" in Issue 1 (Q4 2013) of the Global Financial Markets Insight magazine.*

The total available amount of primary issuance is reduced further if one deducts those securities retained by originators to be used as collateral for Eurosystem operations. In 2014, 70.43% of European securitisation issuance was retained, compared to 58% in 2013 and almost 0% before the crisis. The table below compares current retained issuance to 2007.

TOTAL

MONTH	PLACED	RETAINED	TOTAL	% RETAINED
May-07	89,593.03		89,593.03	0.0%
Jun-07	92,647.64	49.56	92,697.20	0.1%
Jul-07	75,842.38	78.30	75,920.68	0.1%
Aug-07	18,102.56	4,799.22	22,901.78	21.0%
Sep-07	7,628.71	24,125.78	31,754.49	76.0%
Oct-07	5,500.73	67,762.74	73,263.47	92.5%
Jun-13	11,230.42	10,574.99	21,805.41	48.5%
Jul-13	10,464.61	13,499.39	23,964.01	56.3%
Aug-13	3,477.20	4,185.06	7,662.26	54.6%
Sep-13	8,813.51	9,202.57	18,016.08	51.1%
Oct-13	9,872.81	8,843.34	18,716.15	47.2%
Nov-13	13,183.21	26,229.45	39,412.66	66.6%
Dec-13	6,264.93	12,179.00	18,443.92	66.0%
Jan-14	2,370.11	241.29	2,611.40	9.2%
Feb-14	7,149.49	1,209.94	8,359.42	14.5%
Mar-14	10,155.93	5,314.19	15,470.12	34.4%
Apr-14	5,764.25	25,264.37	31,028.62	81.4%
May-14	11,188.96	70,171.92	81,360.88	86.2%
Jun-14	9,617.61	7,942.73	17,560.33	45.2%

European securitisation issuance, US$ million[10]

This is not to say that most European structured finance products have not performed well through the financial crisis with S&P reporting default rates on ABS, RMBS and SME CLOs between July 2007 and Q3 2013 at 0.04%, 0.1% and 0.4% respectively.

LOOKING FORWARD

It seems that the ECB is serious about implementing the proposals. ***"If we were to work on things that don't happen, we wouldn't spend our time well"***, said Mario Draghi in his August address on the issue of whether the ECB would end up buying ABS. The ECB is reported recently to have hired Blackrock as a consultant to help design the programme.

The ECB is ***de facto*** the largest investor in European ABS and so is as keen as any private investor to see an effective and well-functioning market in ABS.

With the announcement of the implementation later in 2014 however we will have to wait to see the detailed structure after the October meeting. This should allow time for regulators to determine the size of the programme and refine their capital and liquidity standards for ABS.

The risk of deflation remains real for the Eurozone. Economic data for Europe through the summer was not good and Draghi and Company need to use every opportunity to drive growth in the European markets.

Authored by: Marcus Lovatt

[10] *Taken from data available at www.sifma.org/*

DLA PIPER: THIS YEAR'S WINNER OF THE PRESTIGIOUS LEGAL BUSINESS AWARDS

LAW FIRM OF THE YEAR: 2014

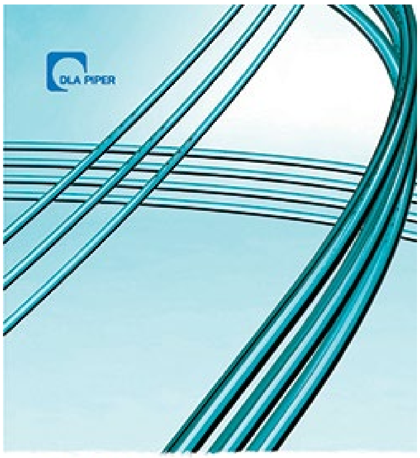
WINNER LEGAL BUSINESS AWARDS 2014 COMPETITION TEAM OF THE YEAR

This year DLA Piper was named Law Firm of the Year by Legal Business.

The accolade is awarded by Legal Business to firms who are considered to have taken the market by storm and achieved more than their direct competitors and peers. It is described by Legal Business as their "most prestigious" award. The judges concluded that this year, in the wake of two years of renewed global growth and ambition, it has been an exceptionally strong year for DLA Piper, becoming the world's largest law firm in terms of revenue, as well as increasing profit per lawyer worldwide.

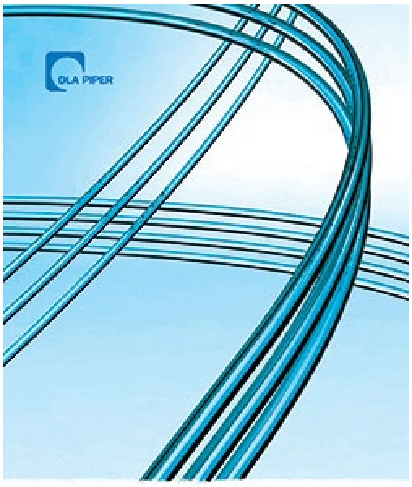
Sir Nigel Knowles, Global Co-CEO and Managing Partner of DLA Piper said: "It is a great honour for the firm to receive this award from Legal Business. As we continue to work towards our goal of being the leading global business law firm, we are very excited about the future and genuinely believe that what we have created will continue to transform and evolve the way that the legal sector operates globally."

AUTO LOAN SECURITISATION



COLLATERALISED
LOAN OBLIGATIONS

DEBT CAPITAL MARKETS/
STRUCTURED AND
PROJECT BONDS



DERIVATIVES

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PORTFOLIO ASSET SALES

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