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A New Era: The New European Framework for Securitisations

On September 30, 2015, the European Commission ("Commission") published two draft regulations as part of the implementation of its Action Plan on Building a Capital Markets Union. The first regulation (the "Securitisation Regulation") will harmonize rules on risk retention, due diligence and disclosure across the different categories of European institutional investors which will apply to all securitisations (subject to grandfathering provisions) and will introduce a new framework for simple, transparent and standardised ("STS") securitisations. The Securitisation Regulation accordingly provides for amendments to be made to the rules relating to securitisations in the Capital Requirements Regulation ("CRR"), the UCITS Directive, the Solvency II Directive, the Alternative Investment Fund Managers ("AIFM") Directive, the Credit Rating Agency ("CRA") Regulation and the European Market Infrastructure Regulation ("EMIR"). The second regulation (the "CRR Amending Regulation") will, for the most part, implement the revised Basel framework for securitisation in the EU and implement a more risk sensitive prudential treatment for STS securitisations.

Following a prolonged period of political scrutiny and negotiation, the texts of the regulations were finally agreed by the three EU legislative bodies on May, 30 2017. Although both regulations are not yet published in the Official Journal, further changes to the texts are now expected to be minor or technical in nature. It is anticipated that the European Parliament and Council will vote to formally adopt the regulations in late 2017 and the regulations will then be published in the Official Journal at the end of 2017 or in January 2018. There are a significant number of regulatory technical standards ("RTS"), delegated acts and guidance which will need to be finalised before the regulations apply from January 1, 2019. The liquidity coverage ratio requirements under the CRR and the regulatory treatment of securitisations under Solvency II will also need to be updated to reflect the final STS criteria.

The EU regulations, when implemented, will have an impact on securitisation markets far beyond the borders of Europe, as issuers and investors in the U.S., Canada, Australia and elsewhere grapple with the consequences of a two-track securitisation regime very different from what is and likely will be in place in their home countries.

Key aspects of the new securitisation framework

Key aspects of the new securitisation framework include the following:

- **Application and Grandfathering:** The Securitisation Regulation will apply from January 1, 2019, subject to grandfathering provisions. The new harmonised rules on due diligence, risk retention and disclosure will only apply to those transactions issued on or after the Securitisation Regulation applies. Transactions issued before this will be subject to the existing rules under the

CRR, the AIFM Directive and the Solvency II Directive, as appropriate. It is currently slightly unclear how the grandfathering rules will apply to transactions with redrawing or advance features (e.g. VFNs) or to ABCP programmes and it is uncertain whether further guidance will be provided. Some transactions issued before January 1, 2019 can become eligible for STS status if they meet certain conditions (see below "STS label and criteria" for more information). A table summarising the grandfathering provisions is set out in Appendix 1.

- **Parties to securitisation transactions:** Investors are generally institutional investors although the Securitisation Regulation does not limit investors to institutions. The Securitisation Regulation also provides for certain retail investors satisfying a suitability test to invest in securitisations, subject to certain conditions.

  Securitisation special purpose entities ("SSPEs") must meet certain requirements regarding taxation, anti-money laundering and transparency if not established in the EU. For STS securitisations, there must be an EU SSPE.

  Originators/sponsors/original lenders must be established in the EU for STS securitisations. A summary of the jurisdiction requirements for securitisation parties and investors for STS and non-STS transactions can be found in Appendix 2.

New harmonised rules on risk retention, due diligence and disclosure: New harmonised rules relating to risk retention, due diligence and disclosure apply across all financial sectors; these will amend the current rules under the CRR, the Solvency II Directive, the AIFM Directive and the Credit Rating Agency ("CRA") Regulation.

- **Due diligence:** The harmonised due diligence obligations on institutional investors are broadly similar to those contained in the current CRR, AIFM Directive and Solvency II legislation; they do not apply to retail investors.
- **Risk retention:** Following much political debate, the level of risk retention remains at 5% for all the five current methods of retention. There will now also be a direct risk retention requirement on originators, sponsors and original lenders to comply with the risk retention rules, in addition the existing indirect requirement upon institutional investors.

  The definition of "originator" in the risk retention rules is amended to provide that an entity cannot be an originator where it has been "*established or operates for the sole purpose of securitising exposures*", to ensure that the originator is an entity of substance. Cherry-picking of assets by originators is prohibited and the Securitisation Regulation provides for sanctions in case of breach of this requirement. RTS will be published providing further detail on risk retention rules.

  The European Systemic Risk Board ("ESRB") is required to continuously monitor the securitisation market in order to prevent systemic risks that may lead to widespread financial distress. Where the ESRB considers it necessary (or at least every three years) the ESRB and the EBA will publish a report on the financial stability implications of the securitisation market and shall provide warnings and issue recommendations for remedial action (including in relation to modifying risk retention levels).

- **Transparency requirements:** These are more detailed than the general disclosure requirements in Article 409 of the CRR and are more akin to the requirements in the Article 8b CRA 3 RTS and include a transaction summary for private transactions. These requirements seem to apply irrespective of whether or not the transactions is private in nature, though it is expected that further clarification will be provided in the related RTS, which will include templates for disclosure taking into account "*the usefulness of information to the holder of the securitisation position*", among other matters. The transparency rules require information to be made available via submission to a securitisation data repository, though private transactions are exempt from this requirement.

  Currently, private and bilateral transactions are exempted from complying with the detailed disclosure requirements under Article 8b and the Article 8b CRA 3 RTS, pending the completion of

work by ESMA on appropriate reporting templates.

- **Credit-granting criteria:** The Securitisation Regulation includes credit granting criteria requiring originators, sponsors and original lenders to apply the same sound and well defined criteria relating to securitised exposures as they apply to non-securitised exposures. They will be required to have clearly established processes and effective systems for the approval, amendment, renewal and refinancing of loans, to ensure that the credit-granting is based on a thorough assessment of the obligor's creditworthiness.

  In addition, where an originator acquires and then securitises exposures from a third party, it will be required to verify that the entity that was involved (either directly or indirectly) in the creation of the original loan agreement creating the exposures met the credit granting criteria. Where the underlying exposures are residential loans, the pool will not be able to include any loans where the intermediary or the borrower is aware that the information provided by the borrower may not be verified by the lender.

- **Re-securitisations:** Re-securitisations are prohibited under the Securitisation Regulation, except in limited circumstances ("*legitimate purposes*"). Fully supported ABCP programmes will not be classified as re-securitisations for the purposes of the prohibition, provided that none of the ABCP transactions within the relevant programme is a re-securitisation and that the credit enhancement does not establish a second layer of tranching at the programme level.

- **Asset features:** It appears that underlying assets comprising receivables with residual values, such as auto finance or lease assets will be permitted under the STS criteria.

- **STS label and criteria:** The STS label will be awarded to term securitisations and ABCP meeting the detailed new criteria for STS transactions. Certain legacy transactions can achieve STS status if they meet specified conditions relating to simplicity, standardisation and transparency. Some of these criteria are measured at the time of issuance and some at the time of notification of STS status; some of these requirements may prove difficult for legacy transactions to meet.

As a result of poor performance of the commercial mortgage-backed securities ("CMBS") market during the last financial crisis, CMBS transactions cannot be STS eligible and currently all synthetic securitisations are also not eligible, though this may change in the future for those synthetic securitisation that are genuinely used by institutions to transfer the credit risk of their lending activity off-balance sheet (balance sheet synthetic securitisations), given the current work being carried out by the EBA on STS eligibility for synthetic securitisations.

The originator, sponsor and SSPE must be established in the EU for a securitisation to be STS eligible. There is no third country equivalence regime included in the final text of the Securitisation Regulation, which means that securitisations with non-EU transaction parties cannot have STS status. When the UK leaves the EU in 2019, transactions involving a UK originator, sponsor or SSPE would no longer be eligible for STS status. The issue of third country equivalence may be considered during the Brexit negotiations as part of a wider discussion on the equivalence of the UK's regime across a wide spectrum of financial services legislation, but it is currently not clear what the outcome of these discussions will be. The review provisions in the Securitisation Regulation also provide for third country equivalence to be considered more generally in the Commission's three year review of the regulation.

In order for a securitisation to be awarded STS status:

- The transaction must meet the appropriate criteria relating to simplicity, transparency and standardisation;
- ESMA must have received notification from the originator and sponsor that the transaction meets such requirements; and
- The transaction must have been added to the list of STS transactions maintained by ESMA on its website.

There are separate but broadly similar requirements relating to simplicity, transparency and standardisation for term securitisations and ABCP, which are intended to take account of their structural differences. The ESAs have been tasked with preparing guidelines and recommendations on the interpretation and application of the STS criteria and also with preparing specific RTS on the homogeneity requirements. The simplicity criteria relating to homogeneity, the restrictions on defaulted loans and the requirements regarding repayment of investors could also be problematic for some types of securitisations. For residential loan and auto loan/lease securitisations, there are obligations to regularly publish information on the environmental performance of the assets financed by the residential loans or auto loans/leases. In addition, the transparency criteria have also raised concerns regarding the requirements for historical data (this is problematic for new types of ABS), file audits of underlying exposures and liability cash flow models.

The Basel Committee on Banking Supervision and the International Organization of Securities Commissions, have recently published a consultation paper setting out draft criteria for ABCP, to supplement the criteria published in July 2015 for term securitisations.

Originators and sponsors are jointly responsible for notifying ESMA that a securitisation is compliant with the STS criteria. Investors can place "*appropriate reliance*" on the STS notification and related information but cannot solely or mechanistically rely on it. The originator, sponsor or SSPE may appoint a third party verifier to check STS compliance but liability under the Securitisation Regulation remains with the originator, sponsor or SSPE. Technical standards will be prepared to specify the content of the STS notification and the template to be used for notification.

- **Liability and Sanctions:** Member states are required to implement appropriate administrative sanctions which are "*effective, proportionate and dissuasive*" (in addition to criminal sanctions) in the event of negligence or intentional infringement where the originator, sponsor, original lender or SSPE has failed to comply with the requirements relating to risk retention, disclosure, criteria for credit-granting, STS criteria or if the originator or sponsor has made a misleading STS notification or failed to notify ESMA and their competent authority that a transaction is no longer STS compliant. Sanctions may take the form of a public statement, a temporary ban from producing STS notifications or a ban against any member of the originator's, sponsor's or SSPE's management body from exercising management functions or a fine (these can vary in size with maximum amounts being set at EUR5m (or the equivalent) or up to 10% of annual net turnover or at least twice the amount of the benefit derived from the infringement (even if this exceeds EUR5m or 10% of annual net turnover)).
- **European Market Infrastructure Regulation ("EMIR"):** The Securitisation Regulation contains amendments to EMIR which provide that derivatives entered into by SSPEs in relation to STS transactions should not be subject to the clearing obligation provided certain conditions are met, including that the OTC derivative contract is used only to hedge interest rate or currency mismatches under the securitisation and that the securitisation arrangements adequately mitigate counterparty credit risk. In addition, in respect of non-cleared derivatives, the level of collateral required should take into account the specific nature of securitisation arrangements and any impediments faced in exchanging collateral.

  The Securitisation Regulation states that the clearing and margin requirements in EMIR should be amended to ensure consistency of treatment between derivatives associated with covered bonds (for which there are already certain exemptions in EMIR) and derivatives associated with securitisations. The EBA is tasked with preparing regulatory technical standards, within 6 months of the Securitisation Regulation coming into force, specifying the criteria for establishing which arrangements under covered bonds and securitisations adequately mitigate counterparty credit risk and the type and level of collateral required by a SSPE.

For information on the impact of the proposed changes to EMIR on securitisation transactions published by the Commission in May 2017, please refer to our client note on Risk of margin posting and clearing for securitization SPVs.

- **Capital treatment**: The CRR Amending Regulation aims to amend the capital requirements in the CRR for institutions originating, sponsoring or investing in STS transactions and address the shortcomings of the current regime, in particular reducing reliance on credit rating agencies by implementing a new hierarchy of the three approaches for calculation of capital requirements and adopting a more risk-sensitive prudential treatment for STS securitisations. It will apply from January 1, 2019 to all securitisation issued on or after that date. Securitisations issued before January 1, 2019 will be subject to the existing CRR rules until December, 31 2019 under the grandfathering provisions; after that date, the new rules will apply. Again, currently it is slightly unclear how the grandfathering rules will apply to transactions with redrawing or advance features (e.g.VFNs) or to ABCP programmes and it is uncertain whether further guidance will be provided.

  Senior positions in STS securitisations will have the advantage of being subject to a lower floor of 10%. A floor of 15% which will continue to apply to non-senior positions in STS securitisations and to non-STS securitisations and a floor of 100% will apply to re-securitisation positions.

  The CRR Amending Regulation provides for the the approaches to calculating risk weights to be applied in the following order: internal ratings based approach ("SEC-IRBA"), standardised approach ("SEC-SA") and then external ratings based approach ("SEC-ERBA"). However, SEC-ERBA may be used instead of SEC-SA where the securitisation exposure is rated (or if an inferred rating can be used) where the application of SEC-SA would result in:

  - A risk-weighted exposure amount higher than 25% for positions in an STS securitisation; or
  - A risk-weighted exposure amount higher than 25% or where the application of SEC-ERBA would result in a risk-weight higher than 75% for non-STS securitisation positions.

  The SEC-ERBA approach can be generally used instead of SEC-SA for auto loans and leases and equipment lease transactions and where institutions have notified the relevant competent authority that they intend to apply SEC-ERBA to their rated securitisation positions instead of SEC-SA.

Appendices

Appendix 1 - Application and Grandfathering Provisions

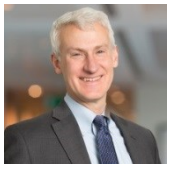
Date of Issuance of Securitisation or Addition or Substitution of New Exposures	Relevant Legislative Provisions
Issued before January 1, 2011 (assuming no new exposures have been added or substituted to the transaction after December 31, 2014)	The Securitisation Regulation will not apply. Existing requirements under the CRR, Solvency II, AIFMD and CRA 3 will apply as appropriate.
Issued on or after January 1, 2011 (or to which new exposures were added or substituted after December 31, 2014) but before January 1, 2019.	The Securitisation Regulation will not apply. Existing requirements under the CRR, Solvency II, AIFMD and CRA 3 will apply as appropriate.
Issued on or January 1, 2019 (or to which new exposures were added or substituted on or after January 1, 2019); and Any securitisation that creates new securitisation positions on or after January 1, 2019	The Securitisation Regulation will apply to all securitisations issued on or after January 1, 2019 but: – If the new risk retention RTS are not adopted by then, the provisions of the existing CRR risk retention delegated regulation will apply until the new RTS are adopted; – If the new RTS on transparency requirements are not adopted by then, sponsors and SSPEs are required to submit some of the required information using the various data reporting templates in Annexes I-VIII of the existing Article 8b CRA 3 RTS until the new RTS are adopted.

Appendix 2 - Jurisdiction Requirements for Securitisation Parties and Investors under the Securitisation Regulation

Entity	STS Transactions	Non-STS Transactions
SSPE	Must be established in the EU.	May be established in the EU or a third country. However, the SSPE must not be established in a third country which does not meet certain taxation or transparency requirements or does not co-operate regarding anti-money laundering or terrorist financing requirements.
Originator/Sponsor	Must be established in the EU. For ABCP, the sponsor must be an EU credit institution supervised under CRD IV.	No requirements on where originators/sponsors must be established.
Investor	Must be either institutional investors or retail clients that have been subject to a suitability test and comply with various investment limits.	Must be either institutional investors or retail clients that have been subject to a suitability test and comply with various investment limits.
	"Institutional investors" include EU-regulated credit institutions and investment firms, insurance and reinsurance companies, occupational pension funds, alternative investment fund (AIF) managers and undertakings in collective investment in transferable securities (UCITS).	"Institutional investors" definition is the same as for STS.

Contacts

Julian Craughan
Partner, London
T +44 (20) 7296 5814
julian.craughan@hoganlovells.com

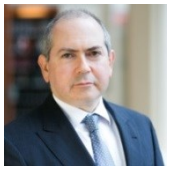


Dennis Dillon
Partner, London
T +44 (20) 7296 2150
dennis.dillon@hoganlovells.com

Tauhid Ijaz
Partner, London
T +44 (20) 7296 5221
tauhid.ijaz@hoganlovells.com

Emil Arca
Partner, New York
T +1 (212) 918 3009
emil.arca@hoganlovells.com

Sven Brandt
Partner, Frankfurt
T +49 (69) 96236 200
sven.brandt@hoganlovells.com



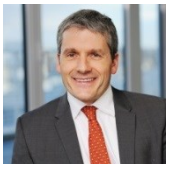
Lewis R. Cohen
Partner, New York
T +1 (212) 918 3663
lewis.cohen@hoganlovells.com

Federico Del Monte
Partner, Milan
T +39 (02) 720252 309
federico.delmonte@hoganlovells.com

Corrado Fiscale
Partner, Milan
T +39 (02) 720252 329
corrado.fiscale@hoganlovells.com

Rachel Pleming
Senior PSL, London
T +44 (20) 7296 5119
rachel.pleming@hoganlovells.com

Julian Fischer
Partner, Frankfurt
T +49 (69) 96236 206
julian.fischer@hoganlovells.com



Baptiste Gelpi
Partner, Paris
T +33 (1) 53 67 22 71
baptiste.gelpi@hoganlovells.com

Dietmar Helms
Partner, Frankfurt
T +49 (69) 96236 260
dietmar.helms@hoganlovells.com

Peter S. Humphreys
Partner, New York
T +1 (212) 918 8250
peter.humphreys@hoganlovells.com

Sharon Lewis
Practice Group Leader, Paris
T +33 (1) 53 67 47 04
sharon.lewis@hoganlovells.com

Robert Masman
Partner, Amsterdam
T +31 (20) 55 33 747
robert.masman@hoganlovells.com

Piotr Zawislak
Partner, Warsaw
T +48 (22) 529-2950
piotr.zawislak@hoganlovells.com

Marc Mouton
Counsel, London
T +44 (20) 7296 2804
marc.mouton@hoganlovells.com