Dechert LLP

New EU Securitisation Regulation: Moving in the Right Direction

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New EU Securitisation Regulation: Moving in the Right Direction

The European Commission published a draft regulation on a European framework for simple, transparent and standardised securitisation on 30 September 2015 (the "Draft Regulation"). The Draft Regulation aims to achieve a better regulated, more transparent securitisation market with the aim of revitalising the European securitisation market, which has not recovered following the global financial crisis in the way that the market has recovered in the U.S. This OnPoint summarises the key provisions of the Draft Regulation and its impact on CLOs.

Key Take Aways

The Draft Regulation:

- revises and consolidates EU securitisation rules, including risk retention, in one regulation;
- applies the revised risk retention rules to originators, sponsors and original lenders as well as investors in securitisations;
- revises the "originator" approach to address regulatory concerns, but should allow properly structured originators (including CMVs and managing C-MOAs) to continue to hold risk retention securities;
- allows existing regulatory technical standards ("RTS"), and the helpful guidance contained therein, to continue to apply until new RTS are adopted;
- sets forth the disclosure and transparency requirements for securitisation transactions; and
- allows for simple, transparent and standardised ("STS") securitisations to be issued and benefit from lower capital charges, subject to certain criteria being met (but excluding actively managed securitisations such as CLOs).

Impact on CLOs

In our view, while there are a number of detailed technical issues that will need to be resolved, the Draft Regulation appears to be a positive development for CLOs in that:

- The Draft Regulation represents a marked departure in tone from the prior proposals, and by introducing a single uniform regulatory framework (including for credit institutions, insurance and reinsurance undertakings and alternative investment funds) will facilitate CLOs by eliminating the sundry and at times differing rules currently applicable to such transactions.
- The Draft Regulation also contains new criteria for "simple, transparent and standardised securitisations" which should apply to certain static CLOs and allow bank investors in such transactions to receive some regulatory capital relief.
- The Draft Regulation appears to replace the prior approaches of the European Banking Authority (including in its December 2014 report) with respect to the so-called "limb (b)" originators based on the originator being an

"entity of substance" that held an asset for a required holding period with a more workable standard focused upon whether the originator "has been established or operates for the sole purpose of securitizing exposures". The extent to which the prior EBA tests will continue to apply will need to be considered.

- Originator funds that are established and operate with multiple business purposes should now be accepted originator-retainers. Similarly, the Draft Regulation will give impetus to properly structured CMVs or C-MOAs that also act as collateral managers. This will assist market participants who wish to comply with both U.S. and EU risk retention.

- While EU risk retention rules previously applied to investors (the so-called "indirect approach"), the Draft Regulation now requires that originators, sponsors and original lenders established in the EU also comply with the risk retention rules (the "direct approach"). For non-EU managers sponsoring securitisations sold into Europe, the indirect approach to risk retention continues to apply. Under previous risk retention rules, the onus has been on EU investors to check that transactions comply, regardless of where any of the other transaction parties are based. Likewise, failure to comply led to penalties (usually in capital risk weights) on investors only.

- The Draft Regulation also imposes disclosure obligations on securitisations including CLOs, however the scope and breadth of these obligations will not be known until the consultation on the new RTS. While current CLO transactions provide substantial disclosure, the industry will need to consult with regulators to ensure that an appropriate level of disclosure for CLOs is reflected in the new RTS and that the new disclosure obligations do not prove impracticable or disruptive to the market.

- Although certain due diligence obligations are not grandfathered and there are some technical difficulties with the wording, the Draft Regulation contains helpful grandfathering provisions which provide that the new regulation will in general only apply to transactions occurring after the Draft Regulation enters into force.

While we are cautiously optimistic, we note that a lot of work remains in terms of finalizing the Draft Regulation. Namely, the Draft Regulation will need to be agreed by the European Parliament and the European Council for adoption. It is possible as part of that process there will be further amendments. In addition, once adopted, there will be some time required for new RTS to be developed. Therefore, in our view, it is unlikely that we will see the Draft Regulation and RTS to be effective in the near term.

To whom does the Draft Regulation apply?

The current framework of securitisation regulation is contained in various European laws. The key legislation is contained in (1) the Capital Requirements Regulation (Regulation 575/2013) ("CRR"); (2) AIFMD (Directive 2011/61); (3) the Credit Rating Agency Directive (Directive Regulation 1060/2009); (4) Solvency II (Directive 2009/138), and (5) the UCITS Directive (Directive 2009/65), plus the associated level 2 regulation and regulatory technical standards related to these. The current legislation imposes requirements on investors in securitisations and also on originators, sponsors, original lenders and issuers, either directly or indirectly.

The Draft Regulation aims to harmonise (to the extent applicable) the regulation of securitisation and address discrepancies which have arisen across the existing legislation. The Draft Regulation therefore applies to (i) all EU "institutional investors" (banks, credit institutions, investment firms, insurance and reinsurance undertakings, AIFMs and UCITS) in securitisations sold in the EU and (ii) originators, sponsors, original lenders and securitisation special purpose entities ("SSPEs") established in the EU.

Risk Retention (Article 4)

The Draft Regulation places the risk retention obligations in one piece of legislation. While this is generally helpful, the Draft Regulation makes some changes to the current risk retention regime primarily laid down in Article 405 of the CRR.

Consistent with the current risk retention regime, the Draft Regulation requires investors to verify, as part of their due diligence prior to investing, that one of the originator, sponsor or original lender will retain a 5% interest in the securitisation. However, the Draft Regulation also imposes the retention obligation as a direct obligation on originators, sponsors and original lenders established in the EU to retain a 5% interest. The obligation remains indirect for originators, sponsors and original lenders incorporated outside the EU who wish to have EU investors in their securitisations.

The direct imposition of a retention obligation, as currently drafted, raises some uncertainty in that it can be interpreted broadly to apply to originators, sponsors and original lenders who are not directly involved in the related securitisation, requiring them to retain a 5% interest. We believe that this is unlikely to have been the regulators' intention and there is other language in the Draft Regulation that suggests that this language was not intended to be read so broadly. We will continue working with regulators and industry participants to clarify this point.

The substance of the retention requirement is mainly unchanged. The methods of retention remain as set out in the CRR and it remains the case that only a limited set of European entities may hold the retention interest on a consolidated basis.

The Draft Regulation specifies that regulatory technical standards in relation to the risk retention requirements should be submitted in draft form no later than 6 months after entry into force of the regulation. The regulatory technical standards will provide greater detail on:

- the modalities of retaining risk, including the fulfilment through a synthetic or contingent form of retention;
- the measurement of the level of retention;
- the prohibition of hedging or selling the retained interest;
- the conditions for retention on a consolidated basis; and
- the conditions for exempting transactions based on a clear, transparent and accessible index.

Clarification of Definition of Originator

One change the Draft Regulation makes to the risk retention provisions is to limit the definition of originator for the purposes of risk retention. An originator is defined in the CRR as "*an entity which: (a) itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposure being securitised; or (b) purchases a third party's exposures for its own account and then securitises them*". The Draft Regulation amends this definition so that, for the purposes of risk retention only "*an entity shall not be considered to be an originator if it has been established or operates for the sole purpose of securitising exposures*".

The new originator restriction is intended to address concerns identified by the European Banking Authority ("EBA") in its December 2014 report, which identified as a "loophole" for abuse the formation of a SPV "originator for a day" to hold risk retention. While the commentary provided with the Draft Regulation is not legally binding, it is helpful in providing guidance on the interpretation of the new sole purpose test: The regulators indicate that an entity cannot be an originator if it is a "dedicated shelf" for the sole purpose of securitising and "without a broad business purpose". From this, it is clear that an originator must have some other business purpose which might include acting as collateral manager or originating loans.

For market participants, the crux will be determining what broad business purpose might be required. The regulation and the commentary, as well as conversations with regulators, have provided some insights:

- We understand that the regulators did not intend to change the status quo for risk retention and while regulators felt that "entity of substance" language was inappropriate for inclusion in the Draft Regulation, originator entities (like the GSO/Blackstone originator entity) having a clear business strategy in addition to securitising, employees, and other factors, remain viable.

- Similarly, originators under limb (a) of the definition (directly involved in origination of loans) already have a broad business purpose in addition to securitising, namely a loan origination business. We note that the "entity of substance" analysis has been used primarily with respect to limb (b) originators (those who buy in the secondary market and then securitise) because originators under limb (a) can be viewed as entities of substance in that they or their related entities have the capital and the business purpose to engage in the business of loan origination.

- It is also our view that a properly structured CMV or C-MOA that acts as collateral manager should also pass muster under the new originator requirements. CMVs and such C-MOAs operate a collateral management business in addition to securitising exposures. This is also consistent with the pronouncements by politicians and regulators on both sides of the Atlantic that the collateral manager should hold the risk retention.

Market participants will also be interested in understanding how significant this other business will need to be. We note that the commentary goes on to state that an originator "has to have the capacity to meet a payment obligation from resources not related to the exposures being securitised". This language was derived in part from Article 147 of the CRR which applies under the specialised lending provisions (e.g. asset finance). The language is intended to reflect the concept that the originator should have an independent credit, i.e. investors in it shouldn't regard the exposure assumed as being equivalent to the retained positions. The language is focused on being able to pay some obligations from cash flow other than cash flow from risk retention securities and it does not suggest that all obligations need to be covered by non-risk retention cash flow.

Due Diligence and Disclosure Requirements (Articles 3 and 5)

The due diligence and disclosure requirements imposed by the Draft Regulation mirror many of the provisions currently imposed on securitisations, either directly or indirectly. It is helpful to have both the due diligence and disclosure obligations in a single piece of legislation and to impose uniform due diligence requirements on all types of investors; however complying with the disclosure obligations may impose additional costs on SSPEs and others. The Draft Regulation also imposes new disclosure requirements; notably the requirement that transaction documents be provided to regulators and investors, which raises concerns about confidentiality.

As contemplated under existing rules, Article 3 imposes due diligence requirements on institutional investors. Investors in a securitisation must verify, before becoming exposed to a securitisation, that:

- where the originator or original lender is not a credit institution or investment firm (as defined in the CRR) the originator or original lender grants all its credits on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits and has effective systems in place to apply these criteria and processes;
- the originator, sponsor or original lender retains a material net economic interest and discloses it to the institutional investor; and
- the originator, sponsor and SSPE make available the information required by and in accordance with the frequency and modalities provided for in the Draft Regulation.

Prior to becoming exposed to a securitisation, institutional investors are also required to carry out due diligence on the securitisation "commensurate with the risks involved". This must include ascertaining:

- the risk characteristics of the individual securitisation position and of the exposures underlying it; and
- all the structural features of the securitisation that can materially impact the performance of the securitisation position, such as the contractual priorities of payment and priority of payment-related triggers, credit enhancements, liquidity enhancements, market value triggers, and transaction-specific definitions of default.

Investors also need to carry out ongoing due diligence while they continue to hold a securitisation position. In summary, investors must:

- establish written procedures commensurate with the risk profile of the securitisation position, and appropriate to their trading and non-trading book where relevant, to monitor compliance with the above requirements and performance of the securitisation position and the underlying exposures on an ongoing basis. Where relevant, the monitoring shall include the exposure type, the percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, recovery rates, repurchases, loan modifications, payment holidays, collateral type and occupancy, and frequency distribution of credit scores or other measures of credit worthiness across underlying exposures, industry and geographical diversification and frequency distribution of loan to value ratios with band widths that facilitate adequate sensitivity analysis. Where the underlying exposures are themselves securitisations, institutional investors shall also monitor the exposures underlying those securitisations;
- regularly perform stress tests on the cash flows and collateral values supporting the underlying exposures that are commensurate with the nature, scale and complexity of the risk of the securitisation position;
- ensure that there is an adequate level of internal reporting to their management body so that they are aware of the material risk arising from the securitisation positions and that the risks from those investments are adequately managed; and
- be able to demonstrate, upon request, to their competent authorities that for each of their securitisation positions they have a comprehensive and thorough understanding of the investment and its underlying

exposures and that they have implemented written policies and procedures for their risk management and recording of the relevant information.

The due diligence obligations imposed on investors are complemented by the disclosure obligations imposed on originators, sponsors and SSPEs under Article 5. The originator, sponsor and SSPE of a securitisation must make available information on the credit quality and performance of the underlying exposures of the securitisation, the structure of the securitisation, the cash flows and any collateral supporting the underlying exposures as well as any information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral supporting the underlying exposures. The Draft Regulation goes into significant detail about the exact nature of the disclosure to be provided and requires the originator, sponsor and SSPE to provide to investors and regulators at least the following:

- information on the exposures underlying the securitisation on a quarterly basis or, in the case of asset-backed commercial paper ("ABCP"), information on the underlying receivables or credit claims on a monthly basis;
- where applicable, the following documents, including a detailed description of the priority of payments of the securitisation:
    - the final offering document or the prospectus, together with the closing transaction documents, excluding legal opinions;
    - for "traditional securitisation" (which is defined as essentially true-sale securitisation) the asset sale agreement, assignment, novation or transfer agreement and any relevant declaration of trust; and
    - the derivatives and guarantees agreements and any relevant documents on collateralisation arrangements where the exposures being securitised remain exposures of the originator:
- the servicing, back-up servicing, administration and cash management agreements;
- the trust deed, security deed, agency agreement, account bank agreement, guaranteed investment contract, incorporated terms or master trust framework or master definitions agreement or other legal documentation with equivalent legal value;
- any relevant inter-creditor agreements, derivatives documentation, subordinated loan agreements, start-up loan agreements and liquidity facility agreements;
- any other underlying documentation that is essential for the understanding of the transaction;
- quarterly investor reports, or, in the case of ABCP, monthly investor reports, containing: (i) all materially relevant data on the credit quality and performance of underlying exposures; (ii) data on the cash flows generated by the underlying exposures and by the liabilities of the securitisation (except for ABCP) and information on the breach of any triggers implying changes in the priority of payments or replacement of any counterparties, (iii) information about the risk retained and other elements required pursuant to the Draft Regulation; and
- where relevant, price-sensitive information required to be disclosed under market abuse rules, or, if the EU market abuse rules are not applicable, the occurrence of any significant event such as:

- a material breach of the obligations laid down in the transaction documents disclosed, including any remedy, waiver or consent subsequently provided in relation to such a breach;
- a change in the structural features that can materially impact the performance of the securitisation;
- a significant change in the risk characteristics of the securitisation and/or of the underlying exposures; and
- any material amendment to transaction documents.

Where the disclosure document does not comply with the Prospectus Directive, a transaction summary or overview of the main features of the transaction must be provided. This must include:

- details regarding the structure of the deal;
- details regarding the exposure characteristics, cash flows, credit enhancement and liquidity support features;
- details regarding the voting rights of the holders of a securitisation position and their relationship with other secured creditors;
- a list of all triggers and events referred to in the transaction documents that could have a material impact on the performance of the securitisation instrument;
- the structure diagrams containing an overview of the transaction, the cash flows and the ownership structure.

Information shall be disclosed via a website which must be free of charge to investors. The website must include a "well-functioning data quality control system" and "include systems to ensure the protection and integrity of the information received", but the Draft Regulation does not specify password protection (we believe this is likely to be required in secondary legislation) or provide details about redaction of commercially sensitive data. The Draft Regulation states that the disclosed information will be available for at least five years after the maturity date of the securitisation. Further details in relation to the disclosure obligations will be specified in regulatory technical standards which will include disclosure templates to replace and expand those created for the Credit Rating Agency Directive.

Simple, Transparent and Standard Securitisations (Articles 6-14)

The Draft Regulation enacts the proposals for a new product: the "simple, transparent and standardised" securitisation. The aim of creating an STS securitisation is to capture and mitigate the major drivers of risk of a securitisation that are not related to the underlying exposures, to improve investor confidence in securitisation products, and to remove the stigma that has affected securitisation since the global financial crisis of 2007. Labelling a securitisation as STS securitisation does not mean that the securitisation is risk-free, but rather that the product respects a number of criteria and that a prudent and diligent investor will be able to analyse the risk involved.

The intention is to strengthen the securitisation markets and to help increase financing to the real economy. As part of this approach, STS securitisations would benefit from a lower capital charge. Despite the improved capital charge, there is still significant concern in the market that the detailed and rigid requirements for an STS securitisation may limit its market acceptance. We note that CLOs and any other actively managed securitisation (as well as synthetic securitizations) are not eligible for this approach.

The Draft Regulation sets out the criteria for an instrument to qualify as an STS securitisation. In summary, the STS criteria include:

- the securitisation is a "true sale" securitisation and is not subject to any severe claw back provisions;
- there are predetermined and clearly defined eligibility criteria for the transfer of exposures from the seller to the SSPE;
- after the closing date of the securitisation there is no active portfolio management on a discretionary basis including the sale of transferred exposures;
- a sample of underlying assets should be subject to external verification prior to issuance by an appropriate and independent party or parties, to verify that the data disclosed in respect of the underlying exposures is accurate, with a confidence level of 95%;
- the securitisation is backed by a pool of underlying exposures that are homogeneous in nature;
- the exposures are contractually binding and enforceable obligations with full recourse to debtors with defined periodic payment streams relating to rental, principal, interest or principal and interest payments, or are rights to receive income from assets specified to support such payments;
- the securitisation is not a re-securitisation;
- the exposures are originated in the ordinary course of the originator's/original lender's business pursuant to underwriting standards that shall not be less stringent than those the originator or the original lender applies to origination of similar exposures not securitised;
- the seller has sufficient experience in originating exposures of a similar nature to those securitised;
- at the time the exposures are transferred to the SSPE none of the exposures are to a credit-impaired debtor or in default;
- at the time of transfer of the exposures, the debtors (or, where applicable, the guarantors) have made at least one payment;
- the repayment of the holders of the securitisation positions shall not depend, substantially, on the sale of assets securing the underlying exposures;
- the originator, sponsor or the original lender retains on an ongoing basis a material net economic interest of not less than 5%;
- interest rate and currency risks arising from the securitisation shall be mitigated and the measures taken shall be disclosed. The underlying exposures shall not include derivatives except derivatives used to hedge currency risk and interest rate risk, which shall be underwritten and documented according to common standards in international finance;
- the originator or sponsor shall provide investors with a liability cash flow model, both before the pricing of the securitisation and on an on-going basis;

- the transaction documentation shall clearly specify the contractual obligations, duties and responsibilities of the servicer and its management team, who shall have expertise in servicing the underlying exposures, and, where applicable, of the trustee and other ancillary service providers as well as the processes and responsibilities necessary to ensure that a default or insolvency of the servicer does not result in a termination of servicing, plus provisions ensuring the replacement of derivative counterparties, liquidity providers and the account bank upon their default, insolvency and other specified events;

- the transaction documentation shall include definitions, remedies and actions relating to delinquency and default of debtors, debt restructuring, debt forgiveness, forbearance, payment holidays, losses, charge offs, recoveries, and other asset performance remedies in clear and consistent terms;

- the transaction documentation clearly specifies the payment priorities, triggers, changes in priority following trigger events as well as the obligation to report such events; and

- the securitisation documentation shall contain clear provisions that facilitate the timely resolution of conflicts between different classes of investors, voting rights shall be clearly defined and allocated to noteholders, and the responsibilities of the trustee and other entities with fiduciary duties to investors shall be clearly identified.

An STS securitisation must also comply with the disclosure obligations imposed by the Draft Regulation (described above), plus certain additional requirements, including a declaration, which is made available on ESMA's website, that the securitisation is an STS securitisation. There are separate requirements for ABCP issuances which are to be STS securitisations. Determining whether a securitisation is an STS securitisation is a matter for the originator, sponsor and SSPE, who shall be liable for any loss or damage resulting from incorrect or misleading notifications.

A securitisation does not have to comply with the STS criteria in order for investors to invest, however it will affect the capital charge levied on a securitisation, which may in practice mean that there is reduced appetite for non-STS securitisations. The draft regulation amending the Capital Requirements Regulation (also published on 30 September 2015) sets out the details of the reduced capital charges. Non-EU issuers of securitisations may wish to consider adapting their issuances to comply with the STS criteria to widen the potential pool of investors, however this does bring increased reporting requirements and potential liability with the consequential increase in costs.

Which transactions are affected?

While certain provisions have been grandfathered, the due diligence provisions of the Draft Regulation apply to all securitisations issued on or after 1 January 2011 and to securitisations issued before that date where new underlying exposures have been added or substituted after 31 December 2014. Accordingly, these provisions of the Draft Regulation will apply retroactively. The European Commission took the view that because the due diligence provisions in the Draft Regulation follow existing provisions, there was no need to provide grandfathering for due diligence. The complementary disclosure rules do not apply retroactively and will only come into force once new regulatory technical standards are adopted to replace the existing regulatory technical standards which apply under the CRR. Investors may need to negotiate with securitisation arrangers in order to get access to information for due diligence purposes until the new regime is fully in force.

The Draft Regulation provides grandfathering for other aspects of the regulation. Securitisations entered into before the date that the Draft Regulation comes into force continue to be governed by the regime in force on the day before the Draft Regulation enters into force. Similarly, relevant portions of the existing regulatory technical standards will continue to apply until new regulatory technical standards are adopted.

The STS criteria will apply from the date the Draft Regulation comes into force but are subject to the publication of regulatory technical standards, which would be required 12 months after the Draft Regulation comes into force.

Sanctions

The Draft Regulation permits each EU member state to determine sanctions for breach of the regulation, by originators, sponsors and original lenders, subject to certain limitations. The Draft Regulation states that a member state may fine an infringer no more than EUR 5,000,000, or (where the infringer is not a natural person) up to 10% of its total annual turnover. Member states may also impose temporary bans on members of that entity's management body from exercising management functions, where a person is held responsible for the breach. Member states may lay down criminal sanctions for infringing the regulation. While sanctions are subject to national implementation, we think it is very unlikely that sanctions could be applied to an entity not established in the EU, beyond reputational "naming and shaming" reports.

Implementation

The Draft Regulation will be transmitted to the European Parliament and the Council for adoption under the co-decision procedure. The European Parliament will now appoint Special Rapporteurs to review the Draft Regulation and discuss any desired amendments to the Draft Regulation. During this period, Dechert will work with various industry bodies to lobby for improvement to the draft to address the concerns raised in this OnPoint. We expect the Draft Regulation to be adopted in early 2016, becoming effective 30 days after publication in the Official Journal of the European Union. As with any other EU regulation, the provisions of the Draft Regulation, once in force, will be directly applicable (i.e. legally binding in all EU Member States without transposition into national law). Draft regulatory technical standards are required to be produced six months after the adoption of the regulation and we expect a relatively brief comment period before the regulatory technical standards are finalised. Dechert will provide regular updates on the progress of the Draft Regulation.

If you have any questions in the meantime, or would like to provide comments to the regulators, please do not hesitate to reach out to your Dechert contacts.

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