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Briefing note

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New Disclosure and Dual Rating Requirements in European Structured Finance

The newly amended credit rating agencies regulation coming into force on 20 June will expand the scope and application of disclosure requirements and other ratings related regulation for structured finance instruments – a concept wide enough to include many transactions not traditionally thought of as securitisations. It imposes potentially extensive disclosure requirements and rules requiring at least two ratings. It also promotes the use of smaller credit rating agencies. Previously it had been possible for parties to ignore most disclosure requirements provided that the transaction in question was not offered to the public or listed on a regulated market. Read on if you are interested in finding out more about the impact of these changes.

On 31 May 2013, an amending regulation that makes several significant changes to the existing Credit Rating Agencies Regulation (collectively, this package of amendments is commonly known as "**CRA3**") was published in the Official Journal of the European Union. CRA3 will come into force on 20 June 2013, being 20 days following that publication.

The headline changes being made by CRA3 are well known – rotation of credit rating agencies for re-securitisations, improved transparency of the debt ratings process, rules to reduce reliance on credit ratings, rules relating to conflicts of interest in the ratings process, increased frequency with which sovereign debt ratings are re-assessed and a uniform civil liability regime for credit rating agencies.

In this note we focus on two further requirements being introduced via CRA3 that have been less well advertised and that will touch in particular on so-called "structured finance instruments". That term is defined by reference to the capital requirements directive. It is wide enough to include most transactions featuring tranched exposure to a pool of underlying assets where the subordination of tranches determines the distribution of losses during the ongoing life of the transaction. This means that many repackagings, certain project and asset finance deals, some real estate finance transactions and potentially certain loans (particularly limited recourse loans) would appear to fall within the ambit of this definition, regardless of whether they would normally be thought of as structured finance.

Whilst typical public securitisations may not find the new requirements too onerous, they may well be particularly problematic for those other transactions caught by the definition of "structured finance instrument".

Disclosure Requirements

CRA3 introduces a broad requirement for the issuer, originator and sponsor of a "structured finance instrument" to jointly publish information regarding the structured finance instrument on a website to be set up by the European Securities Markets Authority ("**ESMA**"). Much remains to be determined by ESMA – in the regulatory technical standards (the "**RTS**") it is required to prepare to flesh out the disclosure obligations – but suffice to say this requirement is potentially wide-ranging, duplicative and problematic. The RTS, however, are unlikely to be adopted until a year or more from now and the disclosure obligations will be impossible to comply with on a practical level until they are.

The requirements are broad both in terms of the transactions apparently covered and in terms of the information required to be published. The new article 1 of the CRA Regulation indicates that the obligations created by the CRA Regulation generally are intended to be imposed upon issuers, originators and sponsors established in the European Union, but beyond that there is no restriction on the deals affected for purposes of the disclosure obligations. This means that a private repackaging structure put in place by a bank with no public offer (exempt or otherwise) and no listing could nonetheless be subject to these disclosure obligations if at least one of the issuer, the sponsor, or the originator was "established" in the EU.

The extent of information required to be disclosed is also quite extensive. According to CRA3, there will be requirements to publish information on the credit quality and performance of the underlying assets, the structure of the transaction, the cash flows, any collateral supporting the exposure and any further information "necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposure". The precise nature of the information to be published, the frequency of publication and the format of publication (in the form of a disclosure template) all fall to be determined by the RTS which are to be developed by ESMA and presented for adoption by the Commission within a year of CRA3 coming into force.

For private deals, the requirement to publish this information would be entirely new and potentially very onerous. A further concern arises because the requirement envisages publication on an ESMA website with no reference to any access restrictions. There is a carve-out from the disclosure obligation where publication would breach national or EU law, but that will be of little assistance, for example, to a bank that would rather not share the details of its private repackaging programme designed exclusively for retained deals in order to manage its various entities' level of exposure to the underlying assets.

For public deals, much of this information will already need to be published or otherwise made available on a website, whether to comply with Prospectus Directive disclosure requirements, risk retention requirements, Rule 17g-5 (for US issuers) or in order to allow the structured finance instrument to meet the eligibility requirements imposed by the Bank of England or the European Central Bank for collateral accepted as part of their liquidity operations. But even for public deals already subject to extensive transparency requirements, additional work may be needed to meet the requirements of CRA3. It is far from guaranteed, for example, that the disclosure timetables and templates to be developed by ESMA will be identical to those put in place by BoE or ECB (which are anyway not identical to one another, though they do require broadly similar kinds of information) or required for other purposes.

The disclosure requirements also face some potential practical difficulties due to the requirement for "joint" publication of the required information. This requirement was presumably included in order to ensure that a structured finance instrument would be caught if any of the issuer, the originator or the sponsor was established in the EU. Unfortunately, it also raises the issues of liability for the information published and how to deal with the situation where one of those parties is not cooperating or, more likely, when there is a disagreement as between the parties as to the precise content of the information to be published.

The silver lining around this particular cloud is the RTS. Although there is no explicit language delaying the effectiveness of the disclosure obligation, it is difficult to see how anyone could comply with it until the RTS are developed by ESMA and adopted by the Commission. Certainly it is impossible to publish information on a website ESMA has not yet created. That means there is likely to be a year or more left before the disclosure requirements become properly effective. The ESMA consultation process on the RTS therefore seems the logical opportunity for the industry to attempt to convince the regulator to limit the scope of the disclosure obligations (for example, to impose only minimal disclosure requirements on structured finance instruments that are neither offered to the public nor listed on a regulated market), to implement access restrictions to certain of the information published on the ESMA website, to clarify the "joint publication" requirement or to deem the disclosure obligations to have been fulfilled if the structured finance instrument meets the transparency requirements imposed by either the BoE or the ECB in respect of eligible collateral.

Dual Rating Requirements

The second requirement is a new obligation for rated structured finance instruments to have at least two credit ratings. It remains permitted for structured finance instruments to be unrated – an approach consistent with the EU authorities' stated objective to reduce over-reliance on credit ratings – but where "an issuer or a related third party intends to solicit a credit rating" it will henceforth be required to appoint at least two credit rating agencies independent of both itself and of each other. Parties to an issuance will further be required to consider appointing at least one CRA with no more than 10% of the total market share (a "**smaller CRA**"), an obligation that may not be limited to structured finance instruments. If the issuer or related third party then goes on to decide against appointing a smaller CRA, this will need to be documented. This is part of the EU's drive to increase competition in the CRA industry.

For mainstream public securitisations and other deals seeking BoE or ECB eligibility, the appointment of two credit rating agencies represents standard practice so will not be regarded as a significant imposition. However, it may be problematic for other "structured finance instruments" where single ratings are more prevalent.

In terms of scope, the obligation to appoint a second rating agency applies to issuers and "related third parties" (a concept which includes originators, arrangers, sponsors, servicers or any other party that interacts with a CRA on behalf of a rated entity). A separate provision states that the regulation creates an obligation on issuers, originators and sponsors "established in the [EU]". Nevertheless there is some uncertainty as to the territorial application of these obligations. For example, it seems unlikely that an issuer established in the EU would be able to escape the obligation to solicit a second rating simply by appointing someone established outside the EU to deal with the rating agencies.

As with the disclosure requirements discussed above, the dual rating requirement is not limited to structured finance instruments offered to the public or listed on a regulated market. The only exemptions available are for those credit ratings that are completely beyond the scope of the CRA regulation. Such exemptions are very limited, covering things like private credit ratings prepared pursuant to a particular order and provided only to the person placing that order.

Similar issues arise as to the scope of the obligation to consider appointing a smaller CRA. In addition, this obligation is expressed in terms that might apply to any issuer or related third party seeking at least two credit ratings, although the general provisions of the regulation do suggest that the intention was that it should create obligations for issuers, originators and sponsors established in the EU "regarding structured finance instruments".

As we mention above, CRA3 will come into force on 20 June 2013. Despite the fact that there is no formal grandfathering of transactions, it is unlikely that the dual rating obligation will apply to existing transactions in the market so long as there is no change in rating agencies. This is because the obligation applies at the point at which "an issuer or a related third party intends to solicit a credit rating of a structured finance instrument". Likewise, the obligation to consider appointing a smaller CRA applies "where an issuer or a related third party intends to appoint at least two credit rating agencies".

The result of this is that there may be some initial "teething" problems related to the precise time at which the intention to solicit a credit rating exists. Clearly if a credit rating has already been assigned to a structured finance instrument on the date CRA3 comes into force, then the relevant point in time has passed and the structured finance instrument will escape the application of the dual rating obligation unless and until there is a change in CRAs at the behest of the issuer or a related party. Equally, the mere fact that preliminary discussions with one or more CRAs have begun on the date CRA3 comes into force may well not be sufficient to prevent the dual rating obligation from applying.

Sanctions

The final area we focus on in this briefing is the question of sanctions. Unfortunately, this is yet another area of uncertainty. No specific sanctions are provided for in the CRA Regulation for the breach of the disclosure or dual rating obligations. The provisions of CRA3 do, however, make explicit that national competent authorities will be responsible for enforcing these provisions. As a result, and despite the fact that no provision is made for Member States to lay down penalties for failures to comply, it seems to us that it will fall to individual Member States of the EU to set out the relevant sanctions. However, it would be for the courts of the individual Member States to decide whether a contravention of the regulation could give rise to civil liability under general principles.

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