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Navigating the Tangled Forest

Securitisation regulation in Europe and the United States

Introduction

This time last year we talked about a picture that was brightening, if still mixed with darker spots, and that largely remains the case. This is not to say that things have failed to move on. The European Commission's Capital Markets Union project has made significant progress. The improved mood music from policy makers and regulators has taken shape as concrete proposals covering "simple, transparent and standardised" securitisation, regulatory due diligence, disclosure and transparency, and risk retention – as well as proposals introducing the new Basel Securitisation Framework for bank capital and integrating the STS concept within it. These proposals have been greeted with enthusiasm by the Council and (as at the time of writing) seem to be receiving a warmer welcome in the EU Parliament than many had expected. The CRA3 public website disclosure obligations that were so hotly debated before being finalised no longer seem likely to be actually be applied. The Volcker rule and Regulation AB II have now mostly settled and US risk retention has caused less market dislocation than many had feared, although it is yet to apply outside the residential mortgage market.

Other than ongoing uncertainty around the practical operation of risk retention and third party due diligence rules – the notable outstanding items on the US securitisation markets' regulatory agenda – things appear to be settling nicely on the American side of the Atlantic. That market has broadly recovered and is an example for Europe of how securitisation markets should operate: deep, liquid and resilient. This is broadly what the Capital Markets Union project seeks to achieve.

Capital Markets Union promises a great deal to securitisation: streamlined and harmonised transparency and disclosure, regulatory due diligence and risk retention requirements; lower capital charges for STS securitisations in the hands of banks and insurers; harmonised criteria for those lower capital requirements, LCR eligibility and better treatment under EMIR. Moreover although they are provided for separately, it looks like these may even overlap significantly with central bank repo eligibility criteria.

The new legislation still has a few hurdles to cross before it is tested in the real world, however. Its journey in the EU Parliament is uncertain and far from complete – it may change significantly there or in the trilogues that follow. This is not to say all change would be bad – indeed some may well be beneficial. Despite promising much, the legislation still fails to provide adequately for existing deals and for private deals, for example. In particular, many challenges remain for ABCP, notwithstanding recent significant moves in the right direction by regulators and policy makers to address them.

Finally, if we are to reach our goal of vibrant, well-functioning securitisation markets around the world we've little choice but to continue travelling through the tangled forest of regulation. Unfortunately the path is not clear and is often difficult to follow. We hope the reflections in this volume help provide you with a few signposts to guide you and show, at least, the direction of travel.

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1. The Securitisation Regulation: where to next?

The proposed Securitisation Regulation will affect most of the important aspects of the regulation of securitisation in the EU. Bank capital, insurance capital, disclosure and transparency, regulatory due diligence, risk retention and liquidity treatment are all contemplated in the EU Commission's proposal, and it seems likely that the effects will spread once the regulation is in place. In this article, we take a look at the main aspects of the regulation: the new simple transparent and standardised ("**STS**") securitisation regime, disclosure and transparency, regulatory due diligence, and risk retention.

STS Practicalities

Much has been written on the STS criteria, which are numerous and detailed. This level of focus is appropriate given that compliance with the criteria will provide access to a far more benign regulatory regime than would otherwise be available for securitisations. This is expected to include lower capital charges for both banks[1] and insurers, exemptions from some of the clearing and margining rules for under EMIR for the associated securitisation swaps, and eligibility for the LCR – plus the possibility of other benefits being introduced later.

That said – and other than the debate about third party certification – relatively little focus has been placed on the practicalities of achieving STS status. Although it was proposed by a number of market participants at early stages, it now seems fairly clear that the final position is unlikely to be one where a regulator (or regulated third party) certifies transactions as STS and all other market participants may then rely on that certification. Instead, the proposed regulation sets out a regime whereby the issuer, originator and sponsor jointly file an STS notification which may (in the EU Council's version of the legislation) include a statement that it has been verified by an authorised third party. Investors are then required as part of their regulatory due diligence to verify whether the criteria have been complied with prior to investing.

All of this creates a kind of market-based, distributed responsibility for STS designation. Although they did not contemplate detailed compliance procedures in the same way as the proposed Securitisation Regulation, the Level 2B securitisation criteria in the context of the liquidity coverage requirement and the Type 1 securitisation criteria in the context of Solvency II provide some guidance as to the way STS categorisation might work. The experience with those two regimes provides some comfort that, even in the absence of a definitive arbiter of STS designation, the market will nonetheless be able to come to sensible conclusions about the meaning of the criteria and, ultimately, which transactions are STS and which are not.

Lessons from the LCR and Solvency II criteria

The broad lesson from the LCR and Solvency II criteria is that it is possible to check most, if not all, criteria based on the offering document in the case of a public securitisation offered by way of a Prospectus Directive-compliant prospectus. The market in these securities generally requires enough information to be disclosed that the securitisation will be able to be sensibly assessed against most of the criteria in the LCR and Solvency II, even if it is found that the securitisation itself doesn't meet those criteria. In fact, when looking at examples of securitisations of the type regulators and policy makers were probably thinking of when coming up with those initial criteria, it is not surprising to find that most criteria are met.

This is not to say, however, that there are not some issues around the edges. The pool homogeneity requirement and the exclusion of credit-impaired obligors are two useful examples that illustrate the issues encountered thus far.

Pool homogeneity

In the case of the pool homogeneity requirement, the issues have arisen largely out of an ill-defined criterion. Taking the Solvency II wording for residential mortgages as an example, the requirement is that the securitisation be "backed by a pool of homogeneous underlying exposures which all belong to only one [category]". One of those categories is "residential loans secured with a first-

1 It is worth noting that the capital relief to be provided to banks is capital relief as compared to the new Basel Securitisation Framework published by the Basel Committee in December 2014, which will dramatically increase the capital banks must hold against securitisation investments as compared to the current system. That new framework is supposed to be implemented in January 2018, but the current CRR amending proposals would bring it in early, along with the STS framework set out in the proposed Securitisation Regulation.

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ranking mortgage granted to individuals for the acquisition of their main residence…".

Although this may seem relatively straightforward on its face, a number of questions arise as soon as it is compared to a real world deal. What if there are multiple mortgages on the home? What if the mortgage loan was not for the acquisition of the borrower's main residence, but refinances a loan that was? What if the mortgage loan is partly for the acquisition (or refinancing the acquisition) of the borrower's main residence and partly for other purposes, such as renovations to that residence? Or perhaps just refinancing other forms of consumer debt, such as credit card debts? These are all common situations and most or all would typically be permitted by the eligibility criteria of a standard UK RMBS transaction, sometimes subject to conditions (e.g. multiple mortgage loans on the same property are usually allowed provided all higher ranking mortgages are also included in the securitisation, and the overall LTV limit is not exceeded).

Although the Solvency II criteria have only been applicable for a relatively short period of time, the market is beginning to get broadly comfortable with all of these situations. As with the introduction of most other new laws, there has been an initial period of uncertainty, but market participants on all sides have worked through these new criteria with their advisers. Because it is in everybody's interests to comply, this not has generally been unduly difficult. Where the deals they are marketing comply, sell side institutions are eager to take full advantage. Accordingly, they will go to some effort to ensure that the buy side has the necessary information to conclude the deal complies. Buy side institutions, in turn, have been making clear to sell side institutions when they need further information or more explicit disclosure in order to come to that conclusion.

Credit-impaired obligors

The situation with credit-impaired obligors has been problematic in a slightly different way. The requirement here is that at the time of issuance (or inclusion in the pool, if later) none of the obligors on the underlying loans should have "declared bankruptcy, agreed with his creditors to a debt dismissal or reschedule or had a court grant his creditors a right of enforcement or material damages as a result of a missed payment *within three years prior to the date of origination*" (emphasis added), nor should any obligor be "on an official registry of persons with adverse credit history", nor should any obligor have "a credit assessment…or…a credit score indicating a significant risk that contractually agreed payments will not be made compared to the average obligor for this type of loans in the relevant jurisdiction".

Obviously this raises some of the same problems of simple uncertainty of the type present with the homogeneity criterion. What is meant by "this type of loans" for the purpose of benchmarking credit scores in the final part of the criterion? Would that make it acceptable to have very poor credit history if it was a specialist payday loan securitisation, for example?

That said, there is the additional problem that this criterion does not reflect an existing best practice in the market – most credit processes simply do not include the three year history required to be disclosed by the criterion. Fortunately, transactions issued before the Solvency II regulation came into force are exempt from this requirement, but that still leaves a sizable stock of receivables that were originated prior to the criteria being published but were not ready to be securitised until after they came into force. Since it would be impractical (if not impossible) to go back and perform these checks, originators will not be in a position to disclose against this criterion and consequently may have difficulty securitising these exposures on reasonable terms, or at all. Going forward, many credit institutions may be able to change their credit processes to check these things, but some may not. There has, for example, been significant concern expressed by some French lawyers about the legality of performing three years worth of checks under French privacy laws.

Given that some of these problems are less susceptible of being resolved by general market consensus, it is perhaps a good thing that the Commission intends to replace these criteria with the STS criteria in due course.

STS criteria and the way forward

Many of the lessons from the LCR and Solvency II can be applied to the new STS criteria. In particular, many of the criteria have been crafted in a way that can be relatively simply and straightforwardly checked in the prospectus. Fortunately some of the lacunae appear to have been corrected as well. For example, the credit-impaired obligor criterion in the proposed Securitisation Regulation is qualified by "to the best knowledge of the originator or original lender", meaning there will presumably be no problems caused by requiring information that hasn't been collected (because it wasn't required at the time of origination) nor will institutions be put in the awkward position of having to choose between STS qualification or complying with local privacy laws.

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Further, while a number of the criteria may not be completely straightforward and clear, the experience of the Solvency II and LCR criteria suggests that the market may be in a position to manage this uncertainty, provided there is a practical mechanism for ensuring quick resolutions where differences of opinion on interpretation do arise. A good example of this is the prohibition on "severe clawback provisions". This is not clear on its face, but the market has been living with some form of this language for many years and is now unambiguously comfortable with it, largely on the basis that the European Central Bank included it in its asset eligibility criteria and has been implicitly making decisions on this for some time now.

Unfortunately, the story doesn't end there. Some of what was got right in the Solvency II legislation, such as grandfathering of existing transactions, is thus far absent from the Securitisation Regulation. What's more, there are a greater number of criteria requiring ongoing monitoring, which will raise the compliance burden for investors. Finally, the criteria are very much designed with public transactions in mind, which ignores the fact that a large proportion of all securitisation activity at the moment is not undertaken with a Prospectus Directive-compliant prospectus.

Grandfathering

While the grandfathering in the Solvency II Regulation may have been imperfect, the Securitisation Regulation does not seem to provide for it at all in respect of the STS criteria. Neither the Commission nor the Council version of the Securitisation Regulation contains this, and (as of the time of writing) there doesn't seem to be any suggestion this is an issue that will be championed by the EU Parliament.

The argument thus far from the Commission is that it would dilute the STS criteria to allow the label to be used by legacy deals that don't comply fully. This is unfortunate, and misses the point for at least two reasons.

The first is that that fails to take account the reason a number of the criteria are present. For example, the requirement that at least one payment has been made on each underlying exposure before it is included in the securitised pool is a fraud prevention measure. That requirement becomes irrelevant in the context of a seasoned securitisation with a credit history and pool performance data of its own. Similar arguments can be made about the requirement that, *at the time of inclusion in the securitised pool*, there may not be any defaulted assets or exposures where the obligor is credit impaired. To require compliance with these criteria before allowing e.g. a three-year old residential mortgage securitisation to qualify as STS clearly serves no purpose.

The second is that the market needs to have critical mass in order to function properly. STS will only work if a large proportion of existing deals are more or less immediately able to qualify. Without that, there is a serious risk of fire sales of existing securitisation positions, effectively punishing existing investors for continuing to invest in securitisations and encouraging them to leave the market – the opposite of the result intended by the STS regime and the Securitisation Regulation more generally. For this reason, it makes eminent good sense to provide grandfathering for technical criteria that attempt to introduce new market standards, such as the requirement to include certain specific perfection events, the requirement that the seller should give certain representations and warranties and the requirement to include certain specific early amortisation triggers. Existing deals are highly unlikely to contain all of these requirements and any attempt to amend transaction documentation to include them would, at the very least, be lengthy and cumbersome – and may well prove impossible in a number of cases.

We understand that the Commission may be prepared to reconsider its stance on grandfathering, and it is to be hoped that this serious flaw in the legislation will be addressed before the end of the legislative process.

Ongoing monitoring

A further difficulty with the STS criteria is the introduction of criteria that require additional ongoing monitoring. Both the LCR and Solvency II criteria require some degree of ongoing monitoring, but these are generally obvious, easy to check and the type of thing any responsible investor would pay close attention to anyway (e.g. the requirements for listing, maintaining a particular credit rating and providing ongoing disclosure). The STS criteria add to this, with a number of criteria that are measured not only at origination or issuance, but thereafter as well. The requirement to "fully disclose" all "material changes in underwriting standards" is a good example. This obligation will fall primarily on originators, but some investors may get nervous that they have to start reading the originator's disclosures unrelated to the securitisation to ensure their ongoing due diligence obligations in respect of this criterion are fulfilled. While we are of the view that this is probably not necessary, it highlights some of the difficulties with certain ongoing obligations and the importance of circumscribing the information investors are required to review in order to fulfil their regulatory due diligence

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obligations more generally. Similar questions could arise with respect to the requirement to mitigate interest rate and currency risks (e.g. where events occur post-issuance that reduce the effectiveness of the mitigation).

The fact that failure to disclose a material change in underwriting standards could easily result from a good faith difference of opinion as to materiality also highlights the importance of proportionate sanctions for failures to comply and the need to mitigate the cliff effects that occur when there is technical (and sometimes temporary) non-compliance with the STS criteria after issuance – although a fuller exploration of these issues is beyond the scope of this article.

Difficulties for private securitisations

The final area of practical difficulty arising out of the STS criteria is that they – like the LCR and Solvency II criteria before them – are largely designed with public securitisations in mind. So while it may be technically possible for private securitisations – which are a large part of the market at the moment – to comply with the STS criteria, it would in many cases be unnecessarily burdensome to do so. Where, for example, a portfolio acquisition is financed by way of a private bank loan that is technically a securitisation, the transparency requirements (which, to be fair, would apply to any securitisation whether or not it is STS) would be excessively burdensome. To then add the requirements relating to disclosure of historical default and loss performance data on similar exposures, and an ongoing liability cash flow model (to name but two) rapidly makes it highly unlikely private securitisation could or would comply. And that is before one begins to consider the difficulties engendered by the STS regime's assumption that there will be an SPV issuer in every securitisation – often not the case in private securitisations, including portfolio financings. Contrary to the intended effect of the Securitisation Regulation, it seems to us that is likely to discourage securitisation rather than encouraging it.

While many of these difficulties are due to the suboptimal definition of securitisation used in the EU with its roots in Basel III, it is nonetheless the case that – unless and until that definition is changed – legislation has to take account of it and provide accordingly.

Conclusion

So a fair bit of good news. The criteria are numerous but broadly manageable. They are not always as precise as one might hope, but there are ways of dealing with this as the market has demonstrated with the Solvency II and LCR criteria. Nonetheless, some significant challenges remain – for legacy securitisations and private securitisations in particular. With some very clear benefits of the STS label laid out – and more likely to come in the foreseeable future – the crucial point for the success of the new regime fundamentally remains how practical compliance will be. It is to be hoped that the difficulties laid out above will be addressed before the Securitisation Regulation is finalised.

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Transparency

Securitisation has always been a data-rich asset class, with the performance of the securitisation investment dependent, ultimately, on the performance of a number – sometimes hundreds of thousands – of underlying assets. For that reason, understanding the creditworthiness of a securitisation is more complex than understanding the creditworthiness of e.g. an individual corporate loan. Not only do investors need an understanding of the behaviour of the individual underlying exposures, they also need an understanding of how those exposures act as a portfolio. After all, if the 2008 financial crisis reminded us of one thing, it was that the performance of the individual exposures in a portfolio may become highly correlated in certain circumstances.

Because of the complexity of the credit analysis, disclosure and transparency have been an integral part of European securitisation markets for a very long time. Even before the financial crisis securitisation transactions provided significantly more data than your typical bond. Nonetheless – and quite understandably – ensuring that the right data is provided at the right time has been a particular focus of regulators, policy makers and central banks since the financial crisis. This was manifested first as the general disclosure requirements under Article 122a(7) of the Capital Requirements Directive (now Article 409 of the Capital Requirements Regulation) and then as loan-level data requirements imposed both by the Bank of England and the European Central Bank as conditions of asset eligibility in their respective repo operations. Most recently, it has taken the form of Article 8b of the Credit Rating Agencies Regulation and its corresponding regulatory technical standards ("**RTS**"). By and large originators have been happy to provide additional information to the extent it is useful to investors. Of these regulatory initiatives, only Article 8b and its RTS have attracted significant industry criticism, and this was because of their:

- *unprecedented broad scope*: effectively all securitisation instruments were intended to be subject,
- *unprecedented broad audience*: all information was to be made freely and publicly available, regardless of whether the deal was private; and
- *unnecessary duplication of efforts:* all information was to be hosted on a website established by the European Securities and Markets Authority ("**ESMA**") (which seemed largely duplicative of the European Datawarehouse) in precisely the prescribed form, regardless of whether substantially similar information was already publicly available elsewhere (e.g. pursuant to existing ECB or BoE requirements).

Fortunately, the requirements of Article 8b seem destined unlikely ever to be practically implemented, with a rumoured repeal via the proposed Securitisation Regulation in the pipeline, and a recent administrative announcement by ESMA appearing to plug what had threatened to be a very awkward gap between the 1 January 2017 application date of Article 8b and the time the new Securitisation Regulation comes into force. Unfortunately, it would appear that the scrapping of Article 8b may come with the loss of a very helpful transitional provision in the Article 8b RTS that exempts securitisations outstanding on or before 26 January 2015. As currently proposed, the transitional provisions in the Securitisation Regulation do not carry over this or any similar exemption, meaning all securitisations would be required to comply with the new disclosure obligations once the Securitisation Regulation begins to apply. This would clearly be problematic and it is to be hoped that this lacuna in the transitional provisions will be addressed before the legislative process concludes.

The Securitisation Regulation will replace rather than simply repealing Article 8b, however. The proposed Securitisation Regulation picks up many of the same themes, but makes a fresh attempt at regulating disclosure for securitisations in a manner that seeks to deal with some of industry's concerns with the Article 8b regime.

The draft Securitisation Regulation and term securitisations

As with Article 8b, the transparency provisions of the draft Securitisation Regulation apply to all securitisations. Although this broadly follows the approach adopted by the Article 8b RTS, the Securitisation Regulation as proposed requires the disclosure to be made accessible only to investors, competent authorities and, upon request, potential investors (although the latter requirement is only in the Council general approach and not the Commission proposal). That said, the draft report prepared by the EU Parliament's rapporteur (the most recent development at the time of writing) suggests the creation of a repository of STS securitisation disclosure data that would be publicly accessible, so there is a possibility that some element of fully public disclosure will be re-introduced, at least for STS securitisations, before the legislation receives final approval.

What needs disclosing and by whom?

The types of information required to be disclosed under the draft Securitisation Regulation are broadly similar to those

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intended to be required under the Article 8b regime. These include:

- the prospectus or other offering document; where no prospectus exists, a summary covering the key features of the securitisation must be provided, but this may included in the non-prospectus offering document;
- the STS notification, where relevant;
- the transaction documents (excluding legal opinions);
- quarterly investor reports covering the credit quality and performance of the underlying exposures, asset and liability cash flows, the breach of any triggers resulting in changes to the priority of payments or replacement of counterparties, and risk retention;
- quarterly loan-by-loan data in prescribed format.

As with the Article 8b RTS, the draft Securitisation Regulation would require disclosure without delay of certain significant events in respect of the securitisation. Where the securitisation is subject to reporting anyway under EU market abuse rules, no further requirements are imposed. Where it is not subject to EU market abuse rules, the draft Securitisation Regulation imposes similar requirements that mimic their effect. The originator, sponsor and the special purpose entity are required to designate amongst themselves one entity to comply with the disclosure rules.

Information must be available free of charge and in a timely and clear manner.

How should information be disclosed?

As with the Article 8b RTS, the draft Securitisation Regulation contemplates the use of disclosure templates for the loan level data. It requires ESMA, in close cooperation with the European Banking Authority and the European Insurance and Occupational Pensions Authority to develop standardised templates for reporting, taking into account the usefulness of information to the investors, whether the securitisation is of a short term nature and, in the case of ABCP transactions, whether it is fully supported by the sponsor. ESMA is likely to have a year to develop these templates. It may be, however, that a year will not be necessary as the templates introduced by the Article 8b RTS represented the product of extensive market consultation and were anyway very similar to the templates developed in the context of the European Datawarehouse for ECB eligibility purposes. The market therefore widely expects that these will be largely recycled and carried over into the new regime – although this will clearly not be possible for ABCP and certain other categories of "private and bilateral" transactions for which further templates were contemplated but never developed under the Article 8b regime.

It is hoped that the regime for private and bilateral transactions, which are by their very nature much more varied and bespoke, will take into account the extensive work done by ESMA and the industry on these transactions before work was suspended on this workstream under Article 8b.

Where should information be disclosed?

This is perhaps one of the most significant areas of difference with the Article 8b regime, which contemplated full public disclosure on a website established by ESMA. As noted above, the draft Securitisation Regulation introduces a more flexible approach. The concept of an ESMA-established website is replaced with a requirement to make information available on a website "free of charge to the holder of a securitisation position and competent authorities, in a timely and clear manner"[2].

In order to comply, the relevant website need not be established by any particular entity or in any particular way, so long as the entity responsible for disclosure:

- develops a well-functioning data quality control system;
- puts in place and maintains adequate organisational structure, respects appropriate governance standards and ensures continuity and orderly functioning;
- sets up appropriate systems, controls and procedures to ensure that the website can function in a reliable and secure manner and identifies sources of operational risk;
- develops systems to ensure the protection and integrity of the information received and the prompt recording of information; and
- ensures that the information is kept and is available for five years after the maturity date of the securitisation.

Additionally, the Council explicitly authorises the use of password protection. That seems superfluous in the context of the Commission proposal limiting the audience to which information must be disclosed. It seems irrelevant whether the limitation of the audience is achieved through password protection, IP address restriction or some other method.

Thus, while the new regime introduces an additional flexibility for originators, sponsors and issuers in terms of how the websites may be set up and run, it also

2 This is the wording of the Commission proposal. As noted above, the Council's general approach document expands the audience to include potential investors upon request.

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potentially shifts the onus of ensuring consistency, integrity and adequacy of the reporting infrastructure onto them. There is no reason, however, that these functions could not be delegated and it seems on its face as though some existing facilities (such as the European Datawarehouse) might fulfil these requirements already.

This clearly represents a step in the right direction from the regime under the Article 8b, especially as concerns the breadth of audience for disclosures in respect of private and bilateral transactions. But is this step big enough to cater for the specific needs and sensitivities of non-public structures? It is not clear what additional benefits the mandatory reporting of particular information at particular frequencies and in prescribed format would confer on investors in a private transaction who, often very small in number, would typically be in a position to negotiate the right to receive the information they find most useful at a frequency of their choosing and in the format they find most convenient.

Special concerns of the ABCP market

Unlike the Article 8b RTS (that explicitly left for later the question of ABCP disclosure), the draft Securitisation Regulation expressly applies to ABCP transactions. Some practical concerns arising from that are discussed below.

Asset level disclosure

The draft Securitisation Regulation extends the requirement to disclose asset level data to ABCP transactions. In its unqualified form, this requirement may create serious practical issues for sponsors of ABCP transactions and the functioning of the ABCP market. First, unlike with other asset classes, there is typically a lot more commercial sensitivity around the underlying transactions and it is not uncommon for originators (who are typically non-financial corporates) to prohibit onward disclosure of information by the sponsor. Secondly, given the short term nature of the underlying assets (e.g. trade receivables), the sheer volume of the asset level data would make compliance extremely difficult, and might not be technically feasible at all.

The Council general approach helpfully relaxes this general requirement and provides that investors and potential investors will only receive access to asset level data in aggregated form. Loan level data will have to be made available only to the sponsor and, upon request, to competent authorities.

There is no indication in the draft of what specific level of aggregation might be appropriate in this context. The current practices of reporting for ABCP transactions involve a high degree of aggregation. Investor reports would typically include concise, often one-page, summaries on a transaction by transaction basis looking at the key economic metrics of each (such as the difference in the balance of receivables during each reporting period, levels of defaults and delinquencies, ineligible receivables, concentration). A similar approach to the level of aggregation would most certainly be helpful although it is unclear whether it will be eventually adopted.

Frequency of reporting and volume of data

The draft Securitisation Regulation requires the asset level data and investor reports for ABCP transactions to be made available on a monthly basis. While monthly investor reporting is already very common, if a sensible balance on aggregation of the asset level data is not achieved, it may present a significant practical challenge.

At this stage, it is unclear whether the more nuanced approach to ABCP transactions included in the Council general approach will prevail, and also what degree of aggregation will be permissible. It is, however, clear that a regime which requires asset level disclosure to the investors and potential investors would certainly make compliance very problematic from both a practical perspective (given the volume of data and monthly reporting) and a commercial one (given the highly sensitive nature of information). It would also give ABCP investors something they are not requesting and do not need.

Conclusion

Much is still left to play for in the field of transparency – particularly surrounding ABCP transactions. That said, it is already apparent that the approach to transparency and disclosure under the draft Securitisation Regulation, while largely similar to the Article 8b regime, should deliver a more nuanced balance between the need for quality information and the practical considerations and commercial sensitivities involved in its disclosure.

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Regulatory Due Diligence

Of all the areas affected by the proposed Securitisation Regulation, regulatory due diligence is probably the one least dramatically affected. Other than the harmonising of due diligence obligations across categories of institutional investor (which is mainly helpful for the sell side, who are not the main targets of these provisions) the changes are by and large minor, technical and helpful. Requirements to check long lists of factors relating to the originator of the securitisation (but not necessarily relating to the securitisation or the underlying assets) are mostly eliminated. Points required to be verified in due diligence are better aligned with those required to be disclosed under the transparency obligations. The list of underlying asset data points to monitor is slightly lengthened, but not in a way that is likely to cause serious problems for the market, and this article will not dwell on them.

The main story when it comes to regulatory due diligence is one of missed opportunities, and important technical points that need fixing in order to make the regime set out in the Securitisation Regulation function properly.

Grandfathering

Clearly the most important of the areas that needs to be addressed in the regulatory due diligence rules is those that affect the grandfathering provisions in respect of risk retention and transparency. Under the transitional provisions in the proposed Securitisation Regulation, transactions can broadly continue to comply with the risk retention rules as they were when the deal was done. It is hoped that the grandfathering rules in respect of transparency obligations will be amended to a similar effect, as discussed in our section on transparency above.

Even so, the due diligence provisions threaten to undermine any good the transitional provisions might do. In both the Commission and Council versions of the text, institutional investors are not simply required to check that the transparency and risk retention rules *applicable to the relevant securitisation* are complied with. Instead, they are required to check that the transparency and risk retention rules *set out in the Securitisation Regulation* are complied with. If these rules were to be enacted as proposed even where a securitisation is legitimately permitted to comply with the risk retention rules under the CRR, it would have to comply with the new Securitisation Regulation rules or become hopelessly unattractive as an investment for EU institutional investors – thereby reducing liquidity, increasing volatility and presumably reducing the price of the security due to drastically reduced demand.

It is hard to believe that this is the intended result, however, and industry has pointed out the problem to the relevant policy makers. It is to be hoped, then, that this issue will be addressed in good time to avoid what would be a very negative – and almost certainly unintended – result.

Delegation of duties

Under the various pieces of sectoral legislation applicable to institutional investors, there has been a level of uncertainty about how to address due diligence obligations where investment discretion is delegated to an asset manager, as is often the case. Where, for example, an insurance company gives an asset manager (itself often an AIFM subject to its own regulatory regime) money to invest, either as part of a fund or on an individual mandate, the insurance company will often not know (much less control) what specific investments are being made on its behalf on a day-to-day basis. To require the insurance company to conduct its own diligence separate from the mandate it has given the asset manager would be inefficient and would defeat substantially the whole of the purpose of granting the mandate in the first place.

The Commission version of the legislation stayed silent on this issue, leaving some institutional investors concerned that they might simply have to stop investing in securitisations, as having to conduct the relevant due diligence themselves would have rendered securitisation investments uneconomic compared to other investments that have no such requirements and that will generally have much lower regulatory capital charges as well.

The Council general approach, however, contains a provision explicitly authorising the delegation of investment management authority to another institutional investor, the effect of which is to transfer the responsibility for conducting due diligence to the managing entity, and relieving the entity with the investment exposure. The Commission has not, to our knowledge expressed any objection to this adjustment, so it seems plausible that this improvement might well make its way into the final legislation.

Limits of investigation

A further source of concern in the proposed rules relating to due diligence is the scope of investigation an institutional investor must conduct in order to satisfy its regulatory obligations. They are

presumably required to familiarise themselves with the prospectus (or other offering document) and the relevant other information required to be disclosed under the transparency provisions. They are also expressly entitled to place "appropriate reliance" on the STS notification where they are investing in a securitisation that is purporting to be STS. Most market participants further assume that these also represent the limits of the investigations institutional investors are required to carry out.

No one is seriously suggesting that institutional investors should audit the books of the originator to double-check the information disclosed in the offering document or the loan-by-loan data disclosures. But the picture becomes less clear when it comes to, say, the originator's annual report and financial statements or its regulatory information announcements unrelated to the securitisation. While these are also probably outside the scope of what needs to be checked in the context of a securitisation investment, a number of institutional investors would certainly appreciate clarity in this respect. Given one of the purposes of the Securitisation Regulation is to encourage investors to join or return to the securitisation markets, drawing a bright line of this type is something that policy makers should at least consider seriously.

Conclusion

Overall the regulatory due diligence provisions in the Securitisation Regulation are a step in the right direction as compared to the existing rules. The changes proposed would largely make the market more efficient and the rules easier to comply with. There is nonetheless room for improvement, including the areas we have set out above. Given that at least one of these areas seems to be a drafting error that would produce an unintended result (grandfathering) and another fix has already been agreed by the Council (delegated due diligence), there is reason for optimism that these provisions may yet come out of the legislative process in a form likely to encourage investors back to the market after all.

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Risk Retention

Risk retention has been one of the key aspects of securitisation regulation since the 2008 financial crisis, and in practice had been a structural feature of many securitisations since well before that. Starting with Article 122a of the Capital Requirements Directive the imposition of a regulatory risk retention requirement sought to align interests and thereby reduce the risks associated with the originate-to-distribute model of securitisation which had been identified as one of the causes of the crisis. In this section, we discuss the potential impact of the proposed Securitisation Regulation on risk retention.

Overview

Thus far, risk retention requirements in Europe have been aimed mainly at regulated investors, with separate sectoral legislation affecting each of alternative investment fund managers ("**AIFMs**"), banks (including investment banks) and insurance companies (including reinsurance companies). While the various regimes are intended to achieve the same results, the legislation is slightly different in each case, and a different sectoral regulator is responsible for the enforcement of each, thereby increasing the possibility of different interpretations being applied to different participants in the same market.
The Securitisation Regulation would do away with this sectoral approach and harmonise risk retention requirements for all institutional investors investing in securitisations (all the while extending the risk retention requirements to UCITS funds, which had been expected eventually anyway). In addition to reducing the risk of varying approaches across different sectors, this would also curtail discussion on transactions in respect of the specific legislation to be referenced in the retainer's representations, warranties and undertakings – a subject that has occupied much transaction team time since the introduction of risk retention requirements for AIFMs and insurers.

A further, more substantive change to the current regime is that the Securitisation Regulation would impose the risk retention requirement on the originator, sponsor or original lender directly – over and above the requirement on institutional investors to check that risk is appropriately retained. This change was foreshadowed by the EBA's December 2014 report on the functioning of the risk retention requirements under the CRR, which concluded that, while the "indirect" approach of the CRR was working and should be retained, a "direct" approach should be introduced to "improve legal certainty for investors, thereby encouraging new securitisation investors to invest" (presumably because as well as relying on ongoing reporting requirements in relation to the risk retention, they would also have the fear of direct regulatory sanctions on the retainer as assurance). The EBA also pointed out that the indirect approach was limited inasmuch as it could only apply to EU regulated institutions and therefore European originators could sell securitisation positions to non-EU regulated institutions or unregulated European entities without having to comply with the requirements. This does beg the question, though, of whether the regulators should be seeking to prevent systemically important European institutions from investing in transactions where there is no-one with skin in the game or trying to stamp out such transactions completely.

The Securitisation Regulation contemplates, in the first instance, the originator, sponsor and original lender (to the extent these are different) agreeing which of them should act as risk retention party. So long as one does, the requirement will be complied with. In the absence of agreement, the Securitisation Regulation puts the obligation on the originator. This is the obvious choice since in many cases the original lender will not be involved and there will be no party falling within the definition of "sponsor" (which the Securitisation Regulation does not propose to amend). This could, however, prove difficult because, as has become apparent under the current regime, there will be transactions in which multiple entities could be the originator, one or more of whom may not even be aware the transaction is taking place. There could also be, especially in the light of the limits on the originator entities who can validly retain risk introduced by the Securitisation Regulation, no originator capable of retaining that is involved in the transaction – this is discussed further below.

Sanctions

If the originator fails to comply with risk retention requirements (and neither the sponsor nor the original lender has agreed to do so instead), what sanctions will apply to it? The Securitisation Regulation puts this decision in the hands of the Member States and their respective regulators but provides that the arsenal of sanctions should include, as a minimum, public censure, fines, bans on the relevant entity's management from exercising management functions and orders for compliance. The Securitisation Regulation also makes reference to the potential for Member States to impose criminal sanctions for the breach of the Securitisation Regulation – though it seems unlikely these would be imposed for breaches of the risk retention requirement alone.

Ban on "special purpose" originators

The draft Securitisation Regulation, having set out the risk retention requirement, goes on to state that, "For the purposes of this Article 4, an entity shall not be considered to be an originator where the entity has been established or operates for the sole purpose of securitising exposures." This is clearly addressing the EBA's concern voiced in its December 2014 report that transaction

parties could use a special purpose vehicle to comply with the second limb of the definition of "originator" ("an entity which purchases a third party's exposures for its own account and then securitises them") without properly aligning the interests of any of the transaction's real architects with its investors. That said, the proposed Securitisation Regulation's articulation of the rule seems to move away from the two tests proposed by the EBA as to whether an entity is an originator within the spirit of the CRR: that it is an entity of real economic substance and that it has held the exposures to be securitised for a minimum period of time before securitising them.

Hopefully the proposed ban on special purpose originators retaining will give increased certainty to market participants compared to the EBA's description, which clearly suffers from an unhelpful lack of clarity and definition. The problems of identifying "real economic substance" and an appropriate "minimum period of time" have been especially acute on more complex transactions where e.g. a consortium of purchasers have wanted to use an SPV to acquire a portfolio of loans for completely legitimate reasons and then finance that acquisition via a securitisation of those loans. That said, the new test is not without its own issues.

First, while this test is objectively more certain than that in earlier drafts rumoured in the market (which had referred to banning retention by originators whose "primary purpose" was acquiring exposures to securitise them) and it is certainly clearer than the EBA's report, it leaves itself open to similar abuses to those possible under the current regime if interpreted literally. For example, if a fund acquires £1bn of mortgages using a thinly-capitalised SPV and then immediately securitises £999,900,000 of them, equity funding the rest, the SPV is clearly not established "solely" to securitise exposures. However, it is clearly not in the spirit of the legislation as its other activities are, relatively, *de minimis*. This case is clearly extreme, and almost certainly untenable in the context that that EU legislation must be interpreted purposively, and not just literally. But that begs the question of where the line is. What value of mortgages would need to be held in the SPV and equity funded before it was not there "solely" to acquire exposures and securitise them? How long would the SPV have to hold the mortgages before securitising them in order to establish the case that it had not "solely" acquired exposures for the purpose of securitising them?

Secondly, it could lead to instances where certain transactions have no originator willing and able to retain. This is problematic when the draft Securitisation Regulation seeks to impose the risk retention obligation on the originator in the absence of agreement. Take the case of a whole portfolio of mortgages acquired via an orphan SPV, with the acquisition concurrently financed by a securitisation of the underlying mortgage loans. As written, the current draft would impose this obligation on the "limb (a) originator", i.e. the original lender or a related party, since the "limb (b) originator" (the SPV) is not capable of retaining under the ban. This is clearly unjust if the limb (a) originator has nothing to do with the securitisation, and partially defeats the purpose of the transaction for the seller, who presumably wants rid of the portfolio entirely.

For these reasons, it seems unlikely we have seen the end of the "real economic substance" and "minimum hold period" tests. Although they are not enshrined in law, they appear to be favoured by the EBA, they are beginning to be understood by the markets and they continue to serve as a useful guide to what is within the spirit of the limb (b) originator definition. In fact, it is more likely that the "sole purpose" test will be added to these two EBA-approved tests.

Other minor changes

There are several further changes introduced to the risk retention regime by the draft Securitisation Regulation. First, risk retention option (b) – originator interest – has been amended to refer to "revolving securitisations", rather than just "securitisations of revolving exposures". This is clearly helpful since revolving trust structure is used in relation to a variety of asset classes rather than just revolving ones such as credit cards.

Secondly, the rules relating to retention on a consolidated basis have been changed such that they no longer require the exposures to have been originated by several different entities within the group – another minor but helpful adjustment.

Conclusion

While the principal changes to the European risk retention rules proposed in the draft Securitisation Regulation are set out above, there are some changes which had been hoped for by market participants that have not been included. For example, managed CLOs still do not fit particularly well within the existing regime. Additionally, while the change to facilitate retention on a consolidated basis is useful, the draft Securitisation Regulation still does not contemplate extending this beyond EU regulated institutions.

Finally, as with the CRR, the draft Securitisation Regulation provides for the publication of an RTS in relation to the risk retention provisions within 6 months of the Regulation coming into force. However, in a quirk of the transitional provisions, it also provides that the current RTS will apply until the new one is published. There will therefore be 6 months where an RTS applies which is based on a disapplied regulation the wording of which, in some respects (e.g. the originator interest retention option), has been superseded.

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2. PD3: what does the CMU mean for the Prospectus Directive?

The Prospectus Directive ("**PD**") regime and its evolution can be viewed as a 'bellwether' for European financial markets and political aspirations. Created in 2003, it was one of the central measures in the EU Financial Services Action Plan ("**FSAP**") and came into force in July 2005. Five years later, its scheduled review ("**PD2**") coincided with widespread disillusionment with financial markets in the aftermath of the 2008 financial crisis. This resulted in some stringent fine-tuning by regulators. Now, as part of its 10 year review ("**PD3**"), the PD regime is once again a flagship for growth. It is a priority measure, along with securitisation, in the EU's new Capital Markets Union ("**CMU**") initiative.

1. PD1: The Prospectus Directive from creation to 2010

Lamfalussy, the Wise Men and the FSAP

Baron Alexandre Lamfalussy, a respected European policy maker, played an integral role in the FSAP over a decade ago. He chaired the "Committee of Wise Men" which developed the four tier legislative approach for regulation of financial markets in Europe, now known as the "Lamfalussy Process". In fact, much of the fabric of our current European financial markets was woven from legislative measures created by the "Wise Men" as part of the EU FSAP – among them, the EU directives and regulations such as the PD.

FSAP and its goals

A priority of the EU FSAP (1999 – 2005) was to create a single, more liquid EU capital market. This was to be achieved through goals such as:

- removing barriers to raising capital on an EU-wide basis;
- providing legal certainty to underpin cross-border trading in securities;
- ensuring that collateral could be accepted cross-border;
- removing barriers in the form of taxation; and
- improving information and transparency.

FSAP and the PD regime

The Prospectus Directive was the 'centrepiece' of the EU FSAP drive to create a '*large, liquid and integrated*' European securities market. Its aim was to make it easier and cheaper for issuers to raise capital throughout the EU and to create a market to rival the size of the United States capital markets. The way in which it sought to achieve this was by creating a uniform offering and disclosure regime across *all* EU Member States. Uniform disclosure would enable issuers to offer their securities to the public in any EU Member State – or to seek admission to trading on any regulated market of an EU Member State – using a single prospectus, approved by a single regulator. This prospectus could be "passported" into another jurisdiction, without any changes – other than, in certain circumstances, a translation of the summary. The PD regime replaced the fragmented mutual recognition approach which previously existed.

Under the previous securities regime, rules for debt securities had drawn a distinction based on the type of *investor* to whom the securities were offered. In contrast, under the new PD regime, a distinction was now also made based on the type of *security* – such as, by reference to its denomination. So, for example, alongside an exemption for offers made to "qualified investors", there was also a public offer exemption in the PD for securities offered which had a minimum denomination of EUR 50,000. Securities offerings with such denominations would not need a PD-compliant prospectus, irrespective of the type of investor to whom they might be targeted.

Where a PD prospectus was required, however, the regime was built on the basis of investor protection through full disclosure. One of the Recitals in the PD states that: "The provision of full information concerning securities and issuers of those securities promotes…. the protection of investors". Having said that, a small distinction was made between the level of disclosure required for debt securities with a denomination of EUR 50,000 and greater ("wholesale securities") and securities with a denomination lower than EUR 50,000 ("retail securities") .

2. PD2: Revisions in 2010, post-financial crisis

This article will not dwell in detail on revisions made as part of PD2,

post-financial crisis, amidst a swathe of other post-crisis legislation. Changes were made through an amending Directive in 2010, implemented in summer 2012, and various Regulations. It is, though, worth highlighting a few facts and trends about the PD2 changes as they help to illustrate why some of the CMU measures are being proposed.

- **PD2 changes in 2010/2012:** Some measures "lightened" the PD disclosure regime in 2012, notably in relation to rights issues and prospectuses for small and medium-sized companies ("**SMEs**"). There was also a step to limit an issuer's concern about so-called "retail cascades" by restricting the ability for someone to use an issuer's prospectus for an offer without the written consent of an issuer. However, the overriding changes which were made under PD2 were seen by many as "consumer protection" measures. These included:
  - increasing the denomination for "wholesale securities" from EUR 50,000 to EUR 100,000;
  - prescribing a very detailed form of prospectus summary, with very precise rules about content;
  - requiring both a summary for a "retail" base prospectus and for any individual tranches of securities issued under them. In practice, this change pushed some programme issuers away from "retail" to the "wholesale" regime; and
  - curtailing the additional information which might be disclosed in the final terms for a transaction under a base prospectus. Instead, it mandated that most information should be contained in the base prospectus and thus reviewed and approved by a regulator (including any formulas, any selling restriction, or any disclosure about an index used for interest calculation).

Taking stock – prospectuses in 2014, pre-CMU

Prospectus approvals: Perhaps unsurprisingly, the number of prospectus approvals peaked pre-financial crisis in 2006 and 2007. Roughly twice as many prospectuses overall were approved across the EU in 2006 or 2007 as compared to 2012, 2013 or 2014. The statistics are, broadly, over 8,000 in 2006 and over 10,000 in 2007, compared with around 4,000 in each the years 2012, 2013 and 2014. More significantly, fewer than a quarter of prospectuses were passported "out", following approval, in any of those years[3].

Number of PD prospectuses approved per year in EEA[4]								
2006	2007	2008	2009	2010	2011	2012	2013	2014
8,005	10,932	6,901	4,909	4,789	4,429	4,100	3,991	3,931

- **Breakdown, by security, of prospectuses approved in 2014:** ESMA figures show that, in 2014 (the latest figures available on the ESMA website) over 60% of the prospectuses approved were for debt securities. Of these, 11.5% were for asset-backed securities ("**ABS**") and 50% for corporate or other debt. (For corporate or other debt, there was an equal split between prospectuses for securities with a denomination of EUR 100,000 ("wholesale" securities) and those for securities with a denomination of less than EUR 100,000 ("retail" securities).)

Proportion of prospectuses by different security types approved in EEA in 2014[5]					
ABS	Debt >100K denomination	Debt < 100K denomination	Shares	Derivatives	Closed-ended investment funds or depositary receipts
11.5%	25.6%	25.0%	21.5%	14.9%	1.5%

3 October 2014 Report (ESMA/2014/1276) ; July 2015 report (ESMA/2015/1136); June 2008 report (CESR 08/452).
4 Source: CESR/ESMA
5 Source: ESMA

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3. PD3 and CMU

CMU: Déjà-vu ?

The goals of CMU outlined in the CMU initiative paper dated 30 September 2015 carry an air of familiarity:

- Identifying barriers and knocking them down one by one;
- Increasing transparency;
- Increasing access to the capital markets;
- Making it less costly for businesses to raise funds;
- Integrating markets;
- Increasing investment choices for retail **and** institutional investors, alike.

Seasoned practitioners might be forgiven for sensing a repeat of the aims of EU FSAP and struggle to guess whether the following statement was made in 1994, 2004 or 2014:

"To improve the financing of our economy, we should further develop and integrate capital markets. This would cut the cost of raising capital, notably for SMEs, and help reduce our very high dependence on bank funding."

Care to hazard a guess?

The author was Jean-Claude Juncker. It was 2014.

In fact, it is not "Groundhog Day"

Many of the goals of CMU seem strikingly familiar (as illustrated by the first sentence in the quote by Jean-Claude Juncker). But there are a number of key differences between FSAP and CMU (as illustrated by the second sentence in the quote).

Chief amongst the differences is the current financial climate. Today's economic, political and financial situation is very different from the era in which the EU FSAP was undertaken: a "brave new world", shortly after the introduction of the euro and monetary union in 1998. So, although the familiar issues surrounding lack of integrated capital markets (with all the problems which ensue) still remain, there is now an additional incentive to encourage greater use of capital markets. This was encapsulated succinctly by Lord Hill in April 2015:

"…over half a century on from the Treaty of Rome, we still don't have a fully functioning single market for capital across the twenty eight Member States. Why should this time be different? Because with low growth and high unemployment the need is greater. And I believe that politicians' will to act is greater…."

There is therefore a strong political and economic imperative to act. As well as the low growth and high unemployment mentioned by Lord Hill, there is also an impression of a reluctance by banks to lend – particularly to small businesses or SMEs – and a lack of growth capital. Given their on-going reliance on bank funding, corporates are facing a crisis of funding. The CMU initiative paper of 30 September 2015 mentions that SMEs currently receive 75% of external funding from loans. Additionally, compared with the United States, European SMEs receive 5 times less funding from the capital markets. Even for larger corporates there is a problem with liquidity – as indicated by the ECB's new Corporate Sector Purchase Programme ("**CSPP**") launched in June 2016. ICMA's 29 April 2016 commentary paper on the forthcoming CSPP reported that the market consensus was that purchases of corporate bonds by the ECB would be in the region of EUR 3-5 billion per month and likely to be skewed towards purchases of newly issued bonds.

The CMU initiative therefore reflects additional goals. These include: widening the investor base for SMEs; developing European private placement markets; building sustainable securitisation; coordinating the approach to European Long Term Investment Funds; improving affordable and independent financial advice for retail investors, and increasing ways to save for pensions and retirement (for example, the CMU September 2015 paper states that the direct share ownership of European households has fallen from 28% in 1975 to 10 or 11% since 2007; furthermore, the proportion of retail investors amongst all shareholders is now less than half what it was in the 1970s).

PD3

How does the PD3 review fit within this context of the CMU initiative?

Given the overall aims of CMU, there is a similar focus in PD3 on improving access for SMEs to the capital markets and, more generally, broadening the retail investor base for shares and bonds. The proposal includes a broader definition of what counts as an SME, with the aim that a reduced "SME disclosure regime" will be available to more potential issuers. There is also an attempt to increase issuance of securities with smaller denominations which might appeal to retail investors.

It is still early days and the legislative process is still underway. Interim and compromise drafts have been released, but feedback to date is that the omission of some contentious areas in the interim drafts does not represent the final position; some have been "parked" for further debate. We have therefore outlined just a few selected issues currently under debate in the short summary table below.

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Finally, for both CMU and PD3, legislators have sought input from a range of interest groups during the legislative process. This has been well received by market participants, as has the willingness of the Commission and Rapporteurs to discuss suggestions with market participants in person. It is also interesting that the CMU consultation last year acknowledged that legislation is not the only way and in some cases market-led developments may provide the way forward. Indeed, Lord Hill acknowledged in April 2015 that: "I do not think that we always have to reach for legislation as a first, or indeed the only, option." There are already some good examples in existence, such as ICMA's Green Bond Principles and the recent ICMA/LMA private placement documentation initiatives. For those measures which are not left to market-led development and for which formal legislation is yet to be agreed, it is to be hoped that the constructive dialogue, to date, achieves a workable PD3 solution for all concerned – issuers, investors, politicians and practitioners, alike.

PD3 – Five selected issues under debate	
EUR 100,000 threshold – "Public offer" exemption	The EUR 100,000 minimum denomination ("wholesale") exemption from the public offer regime prospectus requirement was removed in the Commission first draft in November 2015. The Commission's rationale behind such a proposed change was stated to be to remove any incentive to issue larger denominations. This was intended to encourage issuance of bonds with smaller denominations for retail investors to purchase. This item is still very much under debate.
EUR 100,000 threshold – Differentiated disclosure	In the Commission first draft in November 2015, uniform disclosure across all debt issues was suggested, with the inclusion of a summary for all prospectuses. Should there be identical disclosure for "wholesale" prospectuses (or those targeted at qualified investors) and for "retail" prospectuses (or those targeted at retail investors)? Do professional investors require a prospectus summary, for example – or would it merely be a cost for the issuer? This has been a point of debate.
Risk factors	Categorisation of risks into three groups ranked both by probability of occurrence and likely adverse impact has proved to be a contentious suggestion by the Commission. Its aim was to make risk factors easier for investors to digest and to rely on, but there is a concern that such "crystal ball gazing" would be an impossible task for an issuer. In particular, there are fears that it might lead to more litigation and also make it impossible for issuers to include uniform risk factors across European and other markets, such as the United States.
Summaries	Very short prospectus summaries – and with a limited number of risk factors highlighted in the summary. See "Risk factors" above. Similar concerns would arise.
New concepts	Among the various measures suggested by the Commission as part of its aim to reduce costs and to facilitate access to the capital markets two are generating debate given the lack of clarity surrounding the proposals: a lighter disclosure regime for certain "secondary issuance" by issuers with existing securities; and the concept of "universal registration document" (somewhat akin to a US "shelf prospectus") for frequent issuers, to enable faster access to markets. Market participants currently seem slightly wary of both.

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3. Bank Recovery and Resolution: what impact on securitisation?

Ever since the introduction of the Banking Act 2009 in the UK, the structured debt markets have been preoccupied with ensuring deals were not just "insolvency remote" but also "resolution remote" – a concern that became even more acute with the introduction of the Bank Recovery and Resolution Directive at the European level. A couple of years – and several bank resolutions – on, we take a look at how bank resolution has affected securitisation and what is next in the pipeline.

Background on the BRRD

The European Bank Recovery and Resolution Directive 2014/59/EU ("**BRRD**") aims to harmonise Member States' resolution frameworks for banks and investment firms when the relevant authorities have determined that a bank is failing or likely to fail. It was adopted at the European level in June 2014 and was required to be implemented in national law no later than January 2015 (although a number of Member States failed to do this). The exception to this deadline was the incorporation of the bail-in provisions for which Member States could defer implementation until January 2016. Nevertheless, some Member States, including the UK, implemented these provisions alongside the rest of the BRRD in January 2015.

The key aims of the BRRD are broadly focused on:

(i) *crisis prevention*: individual institutions are required to prepare recovery and resolution plans dealing with financial distress or failure, which the resolution authorities are then required to monitor and assess;

(ii) *early intervention*: granting powers to regulators enabling them to intervene if an institution faces financial distress but prior to the situation becoming critical, such powers include the ability to dismiss management and appoint a temporary administrator;

(iii) *crisis management resolution*: including the use of key resolution tools such as selling the business, setting up a temporary bridge institution, asset separation and the use of bail-in; and

(iv) *cooperation and coordination*: a framework is provided to improve coordination between national authorities in cases where a cross-border banking group fails.

The purpose of the BRRD is essentially to protect financial stability, preserve critical functions, and to avoid the taxpayer having to pay for any losses in the event of failure.

Use of the BRRD

Seen in that light, it makes good economic sense that securitisations should not get caught up in bank resolutions. Securitisations are normally done to provide additional funding (and sometimes capital relief) to banks, so unwinding them as part of a bank resolution would generally harm, rather than help, the situation of the bank being resolved. That is one of the fundamental policy ideas behind the protection of "structured finance arrangements" from the exercise of various resolution powers available under the BRRD. For the same reason, we have known similar protection for "capital market arrangements" in the UK for many years – first as part of the insolvency regime, preserving the right for creditors to appoint an administrative receiver, and later as part of the Banking Act, where "capital market arrangements" were protected from the exercise of the partial property transfer power. This has provided a measure of certainty and comfort to the market that, under those regimes, securitisations were largely protected. The equivalent protections in place under the BRRD, however, have had some measure of uncertainty about them, often because of imprecise or unfortunate drafting either at the European or national levels.

It is therefore reassuring that – so far as public information indicates – things appear to be playing out as expected. While the fact of resolution powers being used and the broad brushstrokes are often public, the details of bank resolutions are almost always hard to come by for those not directly involved. Nonetheless, we do know that, since the adoption of the BRRD, resolution actions have been taken in Austria, Croatia, Finland, Greece, Hungary, Italy and Portugal. We are aware that several of the banks subject to resolution had at least one securitisation outstanding and we are not aware of any situations where securitisations were adversely affected or unwound as part of that resolution.

If anything securitisation seems to be viewed by at least some authorities as part of the solution, rather than as arrangements to be taken apart as part

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of a bank resolution. The resolution tools were used at the beginning of this year in an Italian bank resolution involving Banca delle Marche, Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio di Ferrara and Cassa di Risparmio della Provincia di Chieti. In that resolution, an Italian state guarantee was given on a securitisation of non-performing loans ("**NPL**") to get them off the banks' balance sheets. On 26 January 2016, Italy and the Commission agreed on a structure which uses the bridge bank resolution tool under Articles 40 and 41 of the BRRD and the asset separation tool in Article 42 BRRD. Under the structure, there was to be a transfer of all the assets and liabilities of the banks (apart from remaining equity and subordinated debt) from the banks to the bridge bank. An asset management vehicle was to be set up and the NPLs transferred from the bridge bank to that vehicle. The NPLs were then to be subject to a securitisation and the Italian government would provide a guarantee on the most senior tranche of notes issued. The junior tranches of notes to be sold to private investors (although a rescue fund financed by the larger Italian banks will act as a buyer of last resort) will absorb losses first and are not to be repaid until the guaranteed senior tranches have been repaid in full.

Perhaps the most controversial use of resolution occurred in Portugal in 2014. This concerned the exercise of resolution powers by Banco de Portugal, acting as Portugese resolution authority, over Banco Espirito Santo SA ("**BES**") and involved the creation of a bridge bank. Certain assets were transferred to the bridge bank in order to enable BES to continue on a 'business as usual basis'; BES was then to be wound up in an orderly manner. Following a court ruling in Portugal in 2015, there was a subsequent re-transfer of some liabilities back to BES as the judge found that some of the initial transfers had in fact never been properly made. This case and the subsequent litigation that has ensued (in Portugal and England) illustrates that in effecting the transfers, in particular when effecting partial transfers, there is not always clarity on what has in fact been transferred.

Partial Property Transfer Regulation

As alluded to above, the BRRD provides protection for "structured finance arrangements", among others, from various resolution powers. Article 76 of the BRRD protects structured finance arrangements in the context of the use of the partial property transfer power, though this is subject to additional detail that was to be published at a later date. On 18 March 2016 the European Commission published a Delegated Regulation which provides that detail. The Delegated Regulation is the result of a consultation with the European Banking Authority ("**EBA**") in July 2014 and closely follows the advice provided by the EBA. It will come into force 20 days after it is published in the Official Journal of the European Union, but at the time of writing it has not yet been published.

As mentioned above, the resolution tools allow for the partial transfer of assets, rights and liabilities of an institution. Article 76 provides safeguards for certain contracts in the event of a partial transfer or in the event of forced contractual modifications. Whilst the BRRD determines the form of protection and the limits to the protection, the purpose of the Delegated Regulation is to identify the precise types of arrangements which are to benefit from the protection. The list of protected arrangements is not exhaustive, however, as coming up with an exhaustive list would be highly burdensome, not least because it would require near-continuous updating.

While the Delegated Regulation arguably narrows the safeguards in terms of set off and netting arrangements, one of the key intended beneficiaries of the broader protections which are still available are structured finance arrangements. For these purposes, structured finance arrangements include securitisations, which are defined by incorporating the familiar and most widely used regulatory definition of that term from the Capital Requirements Regulation (the "**CRR**"). The Delegated Regulation makes clear that the scope of protection includes both true sale and synthetic securitisations but – for reasons that are not entirely clear – it does not incorporate the existing definitions of "traditional securitisation" and "synthetic securitisation" from the CRR.

There is some concern over the drafting of the Delegated Regulation since it appears to confer protection to true sale securitisations where the issuer (or investor) is subject to the resolution tools, rather than the originator. This is likely an oversight, however, and representations have been made by industry to the Commission in hopes of having this corrected. In any case, the Delegated Regulation helpfully clarifies that in a true sale securitisation, any role of the originator in the structure, such as servicing the loans, providing any form of risk protection or liquidity, shall be considered as a liability which forms part of the structured finance arrangement, and is therefore protected.

As for a synthetic securitisations, the "security interest" (by which the Delegated Regulation is presumably

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referring to the collateral for the payment of the issuer's obligations – normally in the form of cash or highly liquid securities) is considered to be a right which forms part of the structured finance arrangement only if it is attached to specific and sufficiently identified assets or identifiable assets in accordance with the terms of the arrangement and the applicable national law. We would expect this to be the case anyway, as having effective security over the collateral will require that it be sufficiently identifiable.

In all securitisations, the protection is extended to the relationship the issuer has with third party service providers such as servicers, cash managers, swap counterparties or trustees, provided that the relationships are "mutual" and "directly linked to the underlying assets and the payments to be made from the proceeds generated by these assets to the holders of the structured instruments" – a test that will be easy to meet in most cases.

It is worth remembering that the protections outlined above are not exhaustive and the resolution authority has the discretion, on a case-by-case basis, to include other arrangements within the scope of this provision such that they are subject to the benefits of the safeguard.

From the perspective of the securitisation market the clarification and descriptions of the types of arrangement that benefit from the safeguards in relation to partial property transfers are to be cautiously welcomed. It is helpful, in particular, that the issuer's many relationships with the originator and with third party service providers – without which most securitisations would cease to function – are explicitly protected. It cannot be ignored, however, that – in relation to true sale securitisations – the Delegated Regulation seems mainly to contemplate the situation in which the issuer is in resolution. As the issuer will be a special purpose vehicle, it is difficult to imagine the circumstances where it might be the subject of a bank resolution in its own right. The far more important protection – and one industry has asked the Commission to extend by an amendment to the Delegated Regulation – would be protection for the securitisation in the context of an originator resolution, particularly in situations where there might be some doubt about whether the issuer is a member of the originator's group for BRRD purposes.

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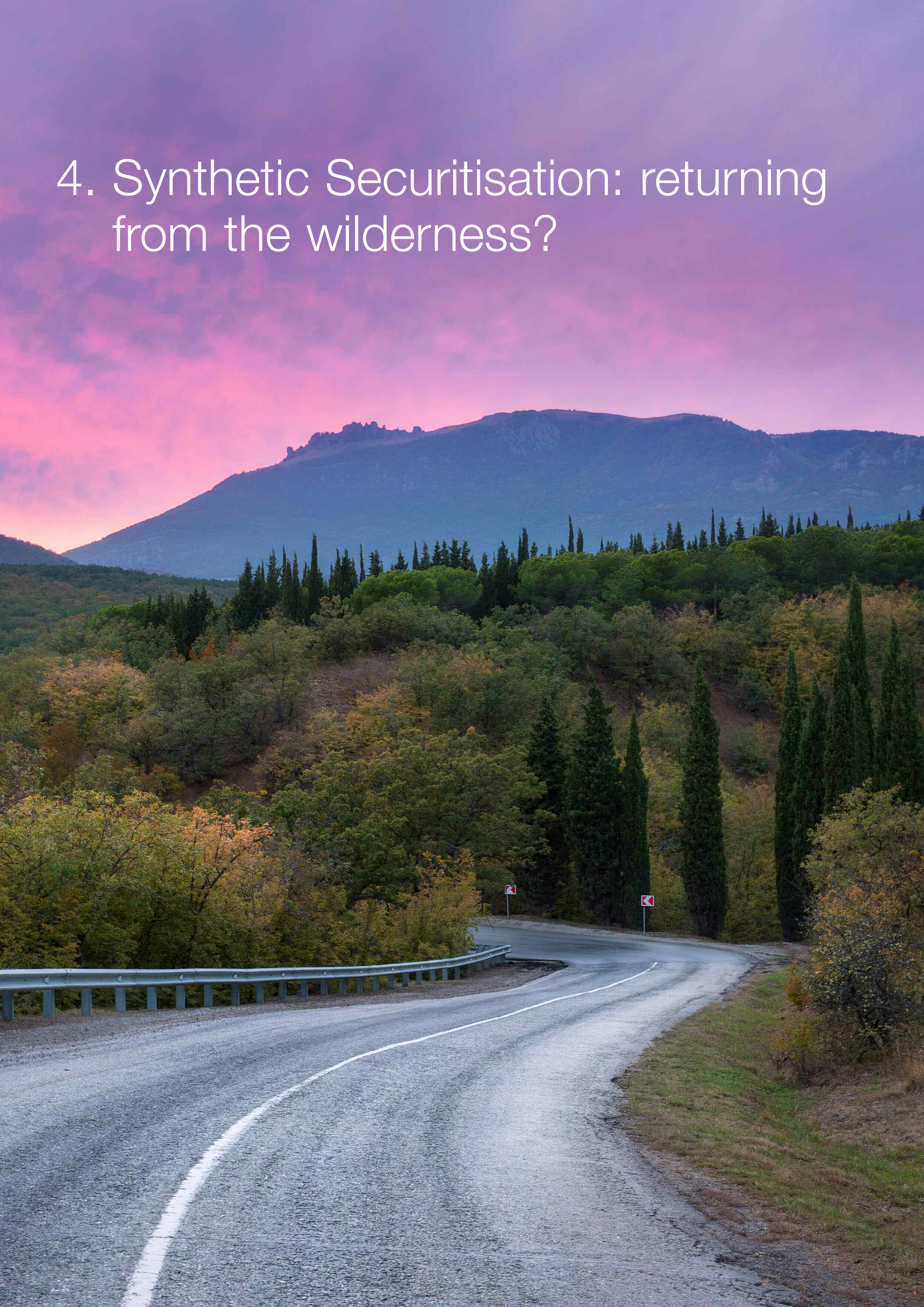

4. Synthetic Securitisation: returning from the wilderness?

Synthetic securitisation, rightly or wrongly, has taken a large share of the blame for the 2008 financial crisis. Perhaps not surprisingly then, it has thus far been left out of plans to introduce a category of securitisations with more benign regulatory treatment, such as the EU's proposed "simple, transparent and standardised" securitisation. In this article, we look more closely at synthetic securitisation, how it might support the goals of the CMU, and the initial signs of a possible thaw in official attitudes to these transactions.

The ugly duckling?

Of the financial products which received much of the blame for the global financial crisis in 2008, few attracted as much negative attention as synthetic securitisation. This was largely due to the way in which synthetic securitisation techniques had been used to amplify the excesses of the US sub-prime housing market, by allowing market participants to take large bets on the risky tranches of sub-prime asset-backed securities, despite having no pre-existing exposure to such securities. The effect of these so-called "arbitrage synthetic securitisations" was that losses in the underlying asset-backed securities could result in many multiples of such losses being suffered by investors in synthetic securitisations referencing those securities. In light of this, when politicians and regulators started to focus on the prime causes of the trouble, it is perhaps unsurprising that synthetic securitisation was identified as one of the main culprits.

However, this critical view of synthetic securitisation ignored the fact that there had been, for many years prior to the onset of the financial crisis, an entirely separate category of synthetic securitisation transactions, usually referred to as "balance sheet" transactions, which had been used by banks to manage their client credit exposures and regulatory capital requirements in connection with their normal lending activity. Unlike the arbitrage transactions, the portfolio of exposures referenced in a balance sheet synthetic securitisation would comprise loans or other exposures on the originator bank's balance sheet, with a one-for-one correlation between the losses the originator would otherwise suffer upon the default of such exposures and the losses to be suffered by investors in the relevant tranche of the securitisation.

In essence, a balance sheet synthetic securitisation is exactly what the name suggests – a securitisation of exposures on the originator's balance sheet, which differs from a true sale securitisation in that the mechanism by which investors in the securitisation derive their exposure to the underlying assets involves a synthetic risk transfer rather than a true sale of the exposures. Broadly-speaking, an investor in a particular tranche of such a synthetic securitisation is exposed to exactly the same risks and losses as an investor in the corresponding tranche of a true sale securitisation of the same portfolio.

There are, however, two ways in which synthetic securitisations in practice tend to differ from true sale securitisation. First, synthetic securitisation tends to be particularly well-suited to those asset types which are, for various reasons, difficult to securitise by a true sale securitisation in some jurisdictions, such as large corporate, SME and trade finance exposures. In addition, synthetic securitisation can also be used to securitise more esoteric securitisation asset classes, such as finance leases, derivative exposures, project finance loans and shipping loans. In contrast, it is unusual to see synthetic securitisation used to securitised residential mortgages, credit cards or auto loans, all of which have well-established true sale securitisation markets.

The second difference relates to the purpose for which an originator bank enters into a synthetic securitisation. True sale securitisation is primarily a funding tool, with the originator looking to sell the senior, highly-rated tranches to investors, while it retains the junior or equity tranches. The effect of this is that, under the securitisation framework in the EU Capital Requirements Regulation ("**CRR**"), the originator will often not have created significant risk transfer in respect of the securitised exposures, or even if it has, its exposure to the junior tranches will result in the securitisation issuer being consolidated onto the originator's balance sheet, such that for regulatory purposes, the originator has the same capital requirements as it would have had had it not entered into the securitisation.
In contrast, in a synthetic securitisation, the originator will usually be looking to sell enough of the risky tranches to achieve significant risk transfer for the purposes of the securitisation framework, while retaining exposure to the less risky senior tranches. As the risky tranches generally

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comprise less than 10% of the notional value of the securitised portfolio, this means that balance sheet synthetic securitisations are of limited use as a funding technique, but are a very effective way of mitigating the credit risk on the securitised portfolio, and consequently reducing the amount of regulatory capital which the originator is required to hold against that portfolio.

In the early years following the financial crisis, relatively few synthetic securitisations were originated. However, in the last few years, there has been a significant increase in the level of activity, and in the last year in particular, this has also been reflected in renewed interest from regulators and policy makers in whether or not synthetic securitisation should be included in the scope of the simple, transparent and standardised ("**STS**") securitisation reforms discussed earlier in this publication. This increased interest also reflects the impact of increased capital requirements for banks, as well as the greater focus on managing credit and lending limits across the banking sector. Thus, what was until recently a fairly small and niche corner of the securitisation market has expanded, with a number of new originators entering the market, and an increase in the number of investors looking to invest in synthetic securitisation transactions.

Pending regulatory changes

As outlined above, synthetic securitisation has been undergoing something of a renaissance in the last few years. This is despite the fact that regulators have retained a cautious approach to such transactions where the originator has been seeking to demonstrate significant risk transfer for the purposes of applying the securitisation risk weightings to the retained senior tranches. This is one area where there has been significant variation among the approaches taken by different regulators across the EU. Although the move to the ECB as the single supervisor for systemically important Eurozone banks is starting to lead to a greater commonality of approach, it is by no means the case that the relevant rules in the CRR are applied in the same way in all jurisdictions.

There are, however, a number of pending regulatory changes which will have a significant impact on the evolution of the synthetic securitisation market in the next few years.

First, synthetic securitisation is currently excluded from the proposed STS framework. One of the key criteria for a securitisation to be classified as STS is that there must be an effective true sale of the securitised exposures to the issuer, which by definition will never be the case in a synthetic securitisation. Thus, even though it is possible for a balance sheet synthetic securitisation to comply with many of the other STS criteria, it seems that synthetic securitisation will, for the present at least, not be capable of being classified as STS.

This is significant because of the impact of the other key regulatory reforms currently being proposed to the CRR, which will increase significantly the risk weightings which apply under the securitisation framework to the senior tranches of all securitisations. These increases will more than double the amount of capital which banks will need to hold in respect of those tranches. However, where a securitisation is classified as STS, the capital requirement is effectively halved. Thus, the exclusion of synthetic securitisation from the STS framework leads to a significant disparity of treatment between a true sale securitisation which complies with the STS criteria and a synthetic securitisation of exactly the same portfolio which economically creates the same exposure for investors. The only current exemption to this disparity is contained in proposed Article 270 of the CRR, which would allow originator institutions to apply the STS risk weightings to the retained senior positions in a synthetic securitisation of SME exposures which otherwise complies with the STS criteria (other than the true sale requirement) and where the credit risk in the tranches not retained by the originator has been transferred to a central government or central bank of an EU Member State, or a multilateral development bank or international organisation which qualifies for a zero per cent risk weight under CRR.

A third pending reform which will also affect synthetic securitisation is a change to the methodologies used to determine the risk weight which applies to a tranche in a synthetic securitisation. Under the current rules, banks which use the Advanced Internal Ratings Based ("**Advanced IRB**") approach are able to calculate the risk weighting for a tranche using what is referred to as the "Supervisory Formula Method". This allows the risk weighted amount to be calculated by reference to the expected losses in respect of the underlying securitised exposures. However, the Supervisory Formula Method can only be used where there is no external rating for the tranches, and no external rating may be inferred from an external rating which applies to other tranches of the synthetic securitisation. Where such ratings are available, the prescribed risk weightings which correspond to those ratings apply. Further, because only Advanced IRB banks can apply the Supervisory Formula Method, banks under the Standardised Approach under CRR can effectively only

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calculate a securitisation risk weighting for a tranche which is rated.

The proposed new arrangements will change both the order in which the methodologies for calculating the risk weightings apply, and the way in which those calculations are actually made. To begin with, for Advanced IRB Banks, subject to certain conditions, they will always be required to calculate the risk weighting pursuant to a revised methodology based on the expected losses for the securitised exposures (referred to as the "SEC-IRBA" approach). Where those requirements are not satisfied (including for banks on the Standardised Approach), a revised version of the ratings based approach will apply if the tranche is rated, with the risk weighting being determined by reference to the rating of the tranche (referred to as the "SEC-ERBA" approach). However, if the tranche is unrated, a new methodology has been introduced, referred to as the "SEC-SA" approach, which calculates a specific risk weighting based on various attributes of the securitised exposures. Nevertheless, while these changes will reduce the need for ratings for banks which are presently unable to apply the Supervisory Formula Method, they are expected in all cases to lead to a significant increase in the overall risk weightings compared with the present situation, particularly for Advanced IRB banks.

STS for synthetic securitisation?

While the door appears shut on synthetic securitisation being included within the scope of the STS framework for the present, there are encouraging signs that this may not always be the case. First, under its proposal for a Securitisation Regulation, the Commission sets out its intention to assess "in the future" whether the STS framework should be extended to include some types of synthetic securitisation, thus opening up the prospect that synthetic securitisations could be brought within the scope of this framework at some point.

Secondly, and rather more pertinently for originators, in 2015 the EBA undertook a consultation and prepared a report on synthetic securitisation. While that report did not recommend the inclusion of synthetic securitisation within the STS framework at this time, it did nevertheless recommend that specific special treatment for the retained senior tranche(s) currently set out in proposed Article 270 of the CRR for synthetic securitisations of SME exposures where the risk on the non-retained tranches has been transferred to a central government, central bank, multilateral development bank or international organisation should be expended to a broader range of synthetic securitisations. Given that, as noted above, originators tend to retain the senior tranches in a synthetic securitisation anyway, if implemented, this extension would provide originators with most of the benefits of STS even if the securitisation would not be classified as STS for other investors.

In order to qualify for this preferential treatment, the synthetic securitisation would need to comply with a number of requirements, of which the most significant are:

- The synthetic securitisation must relate to SME exposures, as defined in Article 501 of CRR. This is perhaps the most significant limitation in the EBA recommendations. In recent years, SME synthetic securitisations have represented approximately one third of overall market volumes, and this is an asset class which is often difficult to securitise using traditional true sale securitisation. However, by far the largest asset class, representing over 50% of all synthetic securitisation issuance, is large corporate loans, and these securitisations would be excluded under the EBA's recommendations. This limitation appears to reflect the political desire to assist lending to SMEs across the EU. Given that in some jurisdictions it is difficult to securitise SME loans through true sale securitisation, this makes SME loans an obvious first asset class to receive a more favourable regulatory treatment.
- The securitised exposures must be denominated in a single currency, which must also be the protection currency. This is also a significant limitation, and is likely to be particularly problematic for banks outside the Eurozone (other than the UK), which may find it difficult to attract investment in their local currency. Even for banks within the Eurozone, the inability to combine assets denominated in multiple currencies into a single securitisation is a significant limitation. It is possible that this is a hangover from the earlier EBA report on qualifying securitisation from July 2015, in which the EBA suggested that exposures should all be denominated in a single currency. However, this was not included in the Commission proposal for STS Securitisation.
- The securitised exposures must be governed by the laws of a single legal system. This limitation appears to be a hangover from the EBA version of the STS requirements for traditional securitisation, where requiring the securitised exposures to be governed by a single legal system was thought to simplify enforcement against the underlying assets should that ever

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become necessary. However, it is difficult to see why this should be a requirement in a synthetic securitisation where any enforcement would be against the collateral for the issuer's obligations and not the reference assets. As with the previous bullet point, this was also a requirement in the EBA report on qualifying securitisation which did not make it into the Commission proposal for STS Securitisation. In addition, there are indications that the reference to a single legal system is intended as a reference to EU law generally rather than the law of individual member state jurisdictions (or sub-jurisdictions).

- Unless the protection seller is a public sector entity which qualifies for a zero per cent risk weighting under CRR, the protection seller must collateralise its obligations to the originator with cash placed on deposit with the protection buyer. While most private sector investors are already accustomed to providing collateral, the desire to limit their credit risk to the originator has seen an increasing trend for cash to be held either with a third party bank or in the form of high quality securities. While the EBA recommendations do not appear to prevent the originator from itself providing collateral for its obligation to repay the deposit, this adds complexity to a transaction.
- As securitised exposures mature or amortise, tranches in the securitisation must amortise sequentially in order of seniority. Pro-rata amortisation is not permitted. This requirement goes against a developing trend in synthetic securitisations in recent years which has seen an originator preference for all tranches to amortise pro-rata, after taking accrued losses into account.

The securitisation must also comply with various other STS requirements which are based closely on the requirements for traditional true sale securitisation, as well as a number of other criteria which are similar to the structural features already common in synthetic securitisations discussed above.

Whether or not the EBA recommendations are adopted by the Commission in some form remains to be seen. At this stage, the indications are that they will not be adopted in the current round of amendments. However, if they are subsequently adopted by the Commission, they must then be considered by the EU Parliament and the Council of the European Union, and an agreed text be approved by all three before the proposals would become law. None of these matters is certain, and it is, of course, possible that at any step along the way, further amendments could be made to the EBA proposals.

Conclusion

As is clear throughout this publication, the regulation of securitisation in the EU has come a long way since the financial crisis. Much of the animosity directed at securitisation generally in the years following the crisis has dissipated, as regulators and policy makers have again come to recognise the importance of securitisation in providing liquidity to capital markets and making credit available to the real economy. Perhaps because of the additional perceived complexity of synthetic securitisation, and almost certainly because of some of the more extreme excesses seen in the arbitrage synthetic securitisation market in the years leading up to the crisis, regulators and policy makers have been slower to accept that synthetic securitisation also has a role to play, particularly in enabling banks to manage their exposures in those asset classes which are difficult to securitise through true sale structures. However, notwithstanding the formidable challenges which still face the synthetic securitisation industry, there are encouraging signs that things are starting to move in the right direction.

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5. Third Party Due Diligence: reports under 15Ga-2 and 17g-10

Since 15 June 2015, all issuers that offer asset-backed securities ("**ABS**") to US investors (including non-US issuers that privately place ABS into the US pursuant to Rule 144A) and their underwriters have been required to comply with rules regarding third-party due diligence reports imposed by the US Securities and Exchange Commission (the "**SEC**"). In particular, under Rule 15Ga-2, the SEC requires issuers and underwriters of ABS to publicly disclose the findings and conclusions of third party diligence reports. In addition, Rule 17g-10 requires third party due diligence service providers, such as accounting firms, to make certain representations to Nationally Recognized Statistical Rating Organizations ("**NRSRO**") regarding their due diligence reports. For these purposes, ABS includes any type of fixed income or other security collateralised by any type of self-liquidating financial asset (such as a loan, lease, mortgage or receivable) that allows the holder of the security to receive payments that depend primarily on the cash flow from the asset.

Third-party due diligence reports

Any report that contains the findings and conclusions of any due diligence services performed by a third party is a "third-party due diligence report" for purposes of Rule 15Ga-2. In this context, the phrase "findings and conclusions" has not been defined by the SEC and remains open to some interpretation.

For purposes of the definition of third-party due diligence report, "due diligence services" includes evaluations of any of the following:

1. the accuracy of the information or data about the assets provided, directly or indirectly, by the securitiser or originator of the assets;
2. whether the origination of the assets conformed to, or deviated from, stated underwriting or credit extension guidelines, standards, criteria, or other requirements;
3. the value of collateral securing the assets;
4. whether the originator of the assets complied with federal, state, or local laws or regulations; or
5. any other factor or characteristic of the assets that would be material to the likelihood that the issuer of the asset-backed security will pay interest and principal in accordance with applicable terms and conditions.

The first four categories address the types of due diligence that the SEC believes is typically conducted for offerings of RMBS, the primary area in which due diligence is conducted. The fifth category is a catch-all for other asset classes where such services may be performed in the future.

Application to agreed-upon procedures performed by accounting firms

Some, but not all, services performed by accounting firms as agreed-upon procedures ("**AUP**") will be considered "due diligence" services. Those services that are not considered "due diligence" will not be subject to these rules. If the primary purpose of the service is to assist issuers and underwriters in verifying the accuracy of disclosures, the service will not be subject to the new rules. Examples of this type of service include performing procedures that tie information included in the offering documents to the loan tape or the financial statements, or recalculations of projections of future cash flows.

AUP services consisting of comparison by accountants of data on a loan tape to a sample of loan files are an example of a service that must be disclosed. This type of review is typically reflected in AUP letters that are delivered to underwriters or initial purchasers for ABS offerings. This type of review is also reflected in Rule 193 letters, which are used by issuers to satisfy SEC-mandated asset review obligations.

When only some of the services performed by an accountant constitute due diligence services, an AUP letter may have two annexes – only one of which reports on "due diligence" services and only that annex would be publicly disclosed.

Application to due diligence reviews performed by law firms

While it is widely understood that Rule 15Ga-2 and Rule 17g-10 do not apply to general legal services traditionally provided in connection with securitisation transactions, these rules do not categorically exclude law firms as due diligence service providers. Whether a legal review performed by a law firm constitutes a third-party due diligence service to which Rule 15Ga-2 and Rule 17g-10 apply depends on a facts and circumstances analysis of the report in light of the relevant regulatory definitions and guidance provided by the SEC. The focus of the analysis is on the purpose of the report, and how closely it resembles a traditional third-party due diligence review conducted in the RMBS space. If the primary purpose of a legal service is to assist issuers and underwriters in verifying the accuracy of disclosures, the service will not be considered to be a third party due diligence service. The interpretation and application of this rule in the context of traditional legal reviews performed in certain non-US markets is still evolving.

Public disclosure of third-party due diligence reports

Under Rule 15Ga-2, the SEC requires any issuer or underwriter of registered or unregistered ABS (including Rule 144A securities) rated by a NRSRO to publicly file a Form ABS-15G on EDGAR, the SEC's electronic document retrieval system, in connection with any third party due diligence reports an issuer or underwriter obtains, which discloses the findings and conclusions of any such third-party due diligence report. Form ABS-15G must be filed on EDGAR at least five business days prior to the first sale in the offering, but it need only be provided with respect to the initial rating of ABS. No filing is necessary in connection with any subsequent rating activities. While this rule contemplates that a Form ABS-15G would be filed by either an issuer or an underwriter, it has become market practice for issuers to bear the responsibility for filing these forms. This allocation of responsibility to the issuer is generally reflected in the underwriting or purchase agreement for a securitisation transaction by the inclusion of a representation and warranty by the issuer that it has prepared and timely filed any required Form ABS-15G.

The Form ABS-15G disclosure may not merely summarise the third-party due diligence report; it must contain the actual findings and conclusions. If the disclosure requirements have been met in the prospectus filed with the SEC (including attribution to the appropriate third-party), and the prospectus is publicly available at the time the Form ABS-15G is furnished by the issuer or underwriter, the Form may refer to that section of the prospectus rather than providing the findings and conclusions once again in full.

A Form ABS-15G filing is not required if an NRSRO engaged to provide an ABS credit rating provides the issuer or underwriter with a representation that it will publicly disclose the findings and conclusions of the relevant third-party due diligence report. If the issuer or underwriter reasonably relies on the NRSRO to make this disclosure and the NRSRO fails to do so in a timely manner, the issuer or underwriter will have until two business days prior to the first sale of such ABS to file a Form ABS-15G. A Form ABS-15G must be filed regardless of whether an NRSRO in fact uses the third-party due diligence report in its credit rating decision.

Whether a Form ABS-15G should cover pre-securitisation due diligence activities (*e.g.*, acquiring underlying assets from the originator or a third-party seller) remains unclear. The regulation requires the filing of a Form ABS-15G in respect of "all third-party due diligence reports obtained by the issuer or underwriter, including interim reports, related to an offering of asset-backed securities."

Redaction of personally identifiable information has been generally viewed as permissible even without submitting a formal confidential treatment request to the SEC so long as the findings and conclusions of the due diligence services can be reported without reference to such information. It has become market practice for the issuer to be responsible for the identification and redaction of such sensitive information so that it is not published as part of a Form ABS-15G, and for the lead manager to have the right to review and approve any such redactions prior to the filing of a Form ABS-15G. An underwriting or purchase agreement for a securitisation transaction may include a representation and warranty by the issuer that no portion of the Form ABS-15G contains personally

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identifiable information (such as names or addresses).

Exemption for non-US transactions

Rule 15Ga-2 does not apply to a non-US offering of ABS where the following conditions are satisfied:

- the offering is not registered (and is not required to be registered) under the Securities Act;
- the issuer is not a "US person"; and
- the security issued by the issuer will be offered and sold upon issuance, and any underwriter or arranger linked to the security will effect transactions of the security after issuance, only in transactions that occur outside the United States.

These conditions specifically exclude any US issuers from relying on the exemption.

Certification requirements for due diligence service providers

When third party due diligence services are employed by an NRSRO, an issuer or an underwriter for ABS, the person providing the due diligence services must provide to any NRSRO that produces a rating for such ABS a written certification mandated by Rule 17g-10 on Form ABS Due Diligence-15E ("**Form 15E**") disclosing who paid for such services, a detailed description of the manner and scope of the due diligence services provided and a summary of the findings and conclusions of the due diligence. The SEC has acknowledged that accounting firms may be reluctant to provide Rule 17g-10 certifications. As a result, the SEC does not object to the inclusion of a description of the standards that govern the performance of AUP on Form ABS Due Diligence-15E. While Rule 17g-10 does not include an exemption for non-US transactions parallel to the exemption provided for Rule 15Ga-2, market participants take the view that it does not apply to Regulation S transactions.

A Form 15E should be delivered promptly after the completion of due diligence services. This timing requirement is generally considered to be satisfied if the Form 15E is delivered within five business days of the final report. It is required not only in connection with any third-party diligence report produced in connection with the initial rating but also in connection with additional due diligence services with respect to ABS offered to US investors throughout the life of the securitisation transaction. Form 15E is not required to be filed on EDGAR. Instead, it is typically posted by the issuer to the Rule 17g-5 website for the transaction. An engagement letters with an NRSRO may include a statement or representation by the issuer that any required Form 15E will be posted to the Rule 17g-5 website.

Transaction considerations

Deal teams should be aware of the third-party due diligence report filing requirements, as the ABS-15G forms are due five business days prior to the first sale. A failure to timely file a report may cause an inadvertent delay in the pricing of an offering. Filing on EDGAR, while simple and straightforward, requires at least two to three business days of lead time for issuers that have not previously obtained the requisite passcodes and identifiers.

In addition, issuers and underwriters will need to consider what, if any, provisions should be added to third-party due diligence service provider engagement letters to ensure that such parties comply with the new requirements, as well as the content and form of the disclosure to be included in the Form ABS-15G. In particular, issuers and underwriters should make sure that the confidentiality provisions in such engagement letters contain appropriate carve-outs to permit transaction parties to comply with these regulatory requirements.

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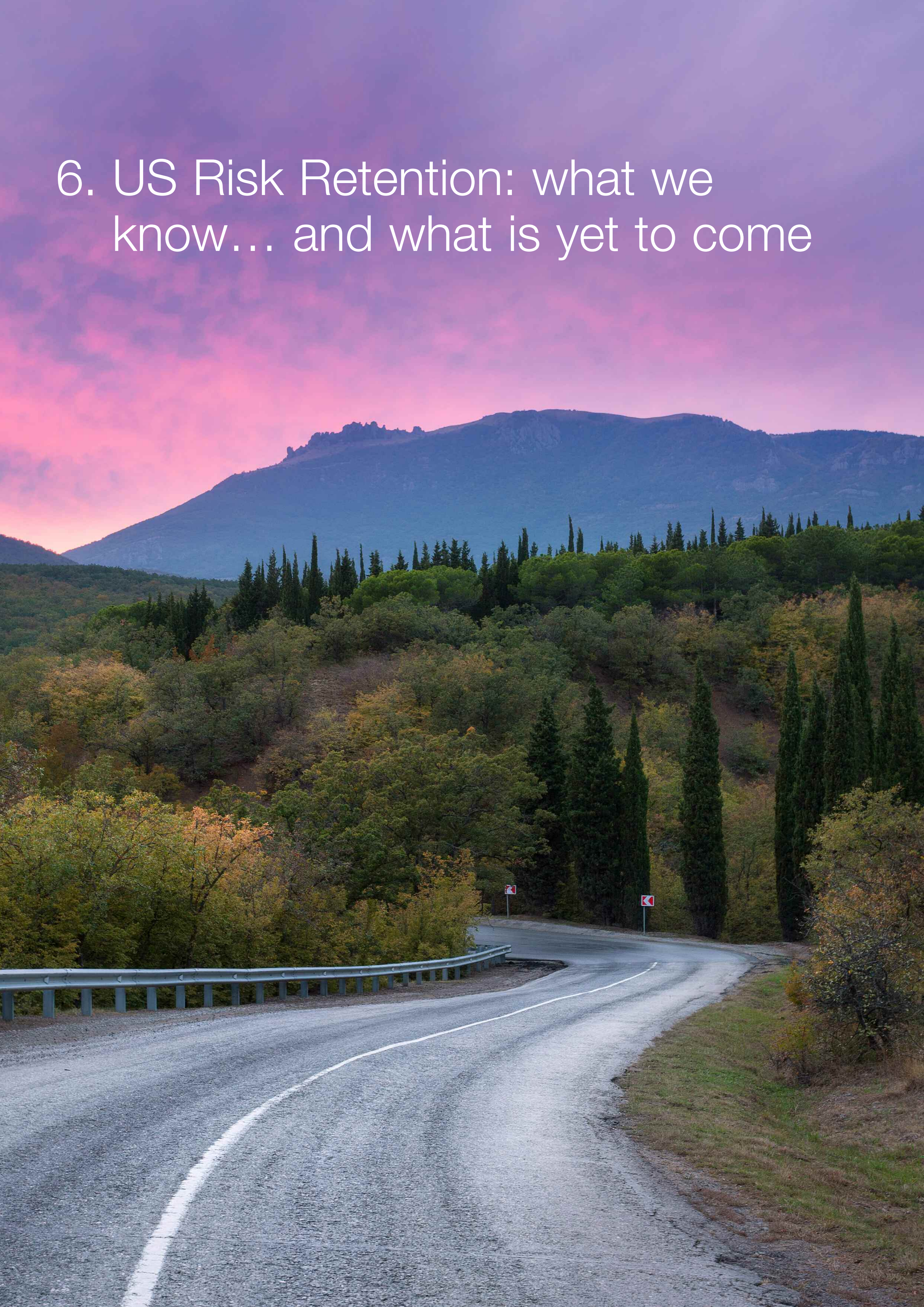

6. US Risk Retention: what we know… and what is yet to come

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") included an amendment to the US Securities Exchange Act of 1934 that requires securitisers to retain at least five per cent. of the credit risk of any asset pool they securitise and prohibits hedging or otherwise transferring such retained risk. Implementing rules were adopted in October 2014 and became effective with respect to residential mortgage backed securities ("**RMBS**") as of 24 December 2015. Compliance with US risk retention requirements will be required as of 24 December 2016 for all other types of ABS, unless an exemption is available. The rules will apply to any issuer of asset backed securities ("**ABS**") to US investors in a private placement under Rule 144A.

The implementing regulations reflect that US credit risk retention requirements are mandatory requirements of the securities laws. If applicable, compliance would be covered by standard no-contravention of law opinions. In the RMBS market, however, it has become common practice for legal opinions to carve out risk retention compliance, as the risk of compliance is allocated to the issuer. These risk retention obligations are designed to apply to private placements in the United States of ABS as well as in registered public offerings. For these purposes, ABS includes any type of fixed income or other security collateralised by any type of self-liquidating financial asset (such as a loan, lease, mortgage or receivable) that allows the holder of the security to receive payments that depend primarily on the cash flow from the asset. The implementing regulations apply the retention requirement directly to the sponsor of a securitisation transaction. A sponsor, in this context, means a person who organises and initiates a securitisation transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity. In addition to several asset-specific exemptions, a narrow exception for specified non-US offerings is available and is discussed below in more detail.

A sponsor may elect to retain the required amount of credit risk indirectly through one or more majority-owned affiliates. A majority-owned affiliate of a sponsor is any entity (other than the issuing entity) that directly or indirectly majority controls, is majority controlled by or is under majority control with, the sponsor. Majority control means ownership of more than 50% of the equity of the relevant entity or ownership of a controlling financial interest (as determined under US GAAP). A limited exception permitting horizontal third-party risk retention by eligible third-party purchasers is available for commercial mortgage backed securities ("**CMBS**") transactions. Even when credit risk is retained by a third party, however, the sponsor will remain responsible for ongoing compliance with the risk retention requirements.

Restrictions on hedging and risk transfers

Retained credit risk may not be hedged or otherwise transferred until the expiration of the relevant transfer and hedging restrictions. During this restricted period, the following actions would nevertheless be permitted:

- A retained interest may be transferred by a sponsor to one or more majority-owned affiliates, or by a majority-owned affiliate to another majority-owned affiliate of the sponsor.
- A retained interest may be pledged to a lender as collateral for a full recourse loan to the sponsor or a majority-owned affiliate, so long as the payment obligations on such loan are not be materially related to the credit risk of the retained interest.
- The sponsor or majority-owned affiliate may hedge the interest rate or foreign exchange rate risk associated with the retained interest.
- Subject to specified limitations, the sponsor or majority-owned affiliate may enter into hedging transactions based on an index of instruments that includes the ABS giving rise to the risk retention obligation.

For all types of ABS other than RMBS, transfer and hedging restrictions will expire on the latest of:

- two years after the closing date of the securitisation;

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- the date on which the total unpaid principal balance of the *securitised assets* that collateralise the securitisation is reduced to 33% of the original unpaid principal balance; and
- the date on which the total unpaid principal obligations under the *ABS interests* issued in the securitisation is reduced to 33% of the original unpaid principal obligations.

For RMBS, the transfer and hedging restrictions will expire on the later of: (1) five years after the closing date for the securitisation; and (2) the date on which the total unpaid principal balance of the securitised assets is reduced to 25% of the original unpaid principal balance, but not later than seven years after the closing date. A limited exception to these transfer restrictions is available for CMBS risk retention involving eligible third-party purchasers.

Permitted forms of risk retention

US risk retention requirements allow a sponsor to satisfy its risk retention obligation by retaining an eligible vertical interest ("**EVI**"), an eligible horizontal residual interest ("**EHRI**"), or a combination of these two forms. While EHRI may be more cost effective than EVI, some sponsors of RMBS have found EVI easier to comply with, because the required fair value calculations and related disclosure obligations (applicable only to EHRI) have proven difficult in practice. The federal regulators have also adopted tailored alternative risk retention options for specific types of asset classes, such as revolving pool securitisations and asset-backed commercial paper. These alternatives, however, do not include any representative sample method.

Vertical risk retention

If the sponsor chooses to retain risk using an EVI, the sponsor must retain either a percentage interest in each class of the ABS interests issued as part of the securitisation transaction or a single vertical security that entitles the holder to a specified percentage of the amounts paid on each other class of ABS. For example, if four classes of ABS interests are issued in a securitisation transaction, the sponsor would satisfy its risk retention obligation by retaining five percent of each of the four classes. If the sponsor were to retain four percent of three classes and seven percent of the fourth class, it would be deemed to only be retaining a four percent interest (but note the option to hold a hybrid risk retention interest described below). In selecting between the two options, a sponsor planning to use the EVI as collateral for a full recourse loan may want to consider whether potential lenders would have a strong preference for one form of EVI over the other.

Horizontal risk retention and eligible horizontal cash reserve accounts

An EHRI may be the most junior class of ABS interests in the issuing entity or multiple contiguous classes representing the first loss position in the securitisation transaction. On any payment date on which the issuer has insufficient funds to pay all interest or principal due, any resulting shortfall must reduce amounts payable to the EHRI prior to any reduction in the amounts payable to any other ABS interest (whether through loss allocation, operation or priority of payments or other contractual provision).

The percentage of risk retention credit for an EHRI is determined by reference to the fair value of all ABS interests issued as part of the securitisation transaction, using US GAAP. In adopting the implementing regulations, US regulators specifically declined to permit non-US securitisers to use any alternative fair value measurement methods that would be permitted under IFRS or home country GAAP. Sponsors who use EHRI to satisfy their risk retention obligations are subject to extensive disclosure requirements regarding key information about the methodologies and assumptions that they use to calculate the amount of their eligible horizontal residual interests in accordance with fair value standards. They must provide these disclosures to investors at two points in time: (1) a reasonable period of time prior to the sale of ABS; and (2) at a reasonable time after the closing of the transaction. In RMBS transactions, the fair value determination and disclosure requirement have been challenging to comply with, leading some sponsors to rely on EVI to satisfy their risk retention obligations.

Instead of retaining all or a portion of the credit risk in the form of an EHRI, a sponsor may elect to establish and fund an eligible horizontal cash reserve account ("**EHCRA**"). The risk retention percentage attributable to the cash in an EHCRA would be determined with reference to the fair value of all ABS interests issued in the securitisation transaction. This option is attractive for types of securitisation that typically include cash reserve accounts. To qualify, the account must be held by a trustee in the name and for the benefit of the issuer, and amounts in the account can only be invested in cash and cash equivalents. Amounts may be released from an EHCRA to:

- satisfy payments on ABS interests in the issuer on any payment data on which the issuer has insufficient funds from any source to satisfy an amount due on any ABS interest; or

- pay critical expenses of the trust to a person not affiliated with the sponsor, which payments must be unrelated to credit risk, on any payment date on which the issuer has insufficient funds from any source to pay such expenses and such expenses would otherwise be paid prior to any payments to holders of ABS interests.

The implementing regulations do not affirmatively require that the reserve funds be used to cover all types of payment shortfalls. Accordingly, an EHCRA may be structured to only cover a subset of shortfalls – such as only shortfalls on interest payments on a senior tranche of ABS interests.

Hybrid risk retention

A sponsor may choose to retain any combination of EVI and EHRI as long as the sum of the percentage of the EVI plus the percentage of the fair value of the EHRI is no less than five percent. For example, if a sponsor elects hybrid risk retention and retains a single vertical security representing three percent of the cash flows paid on each class of ABS interests (other than the vertical security itself), then that sponsor would also need to hold at a minimum an EHRI with a fair value (determined in accordance with US GAAP) of two percent of all the ABS interest in the issuer.

Third-party risk retention option for CMBS transactions

In the US market, it is common in CMBS transactions for third-party purchasers to purchase of a first-loss position (known as a B-piece). In recognition of this market practice, the Dodd-Frank Act gave federal regulators authority to create a third-party risk retention option for CMBS transactions. Under the implementing regulations, either one or two (but no more than two) eligible third-party purchasers will be permitted to satisfy the risk retention requirement by acquiring an EHRI. If there are two third-party purchasers, neither third-party purchaser's losses may be subordinate to the other's losses. In cases where credit risk is retained by an eligible third-party purchaser, the sponsor will nevertheless remain responsible for ongoing compliance with US risk retention requirements.

The two third-party purchaser limit and the inability of a third-party purchaser to take advantage of risk retention in the form of an EVI may deter use of this option. Traditional B-piece buyers may not have sufficient capital to retain EHRI in amounts likely to be much larger than they have historically purchased. In addition, CMBS lenders may not be willing to take on liability for non-compliance by a B-piece investor with the risk retention requirements. As a result, the CMBS market is still developing solutions, such as traditional B-piece purchasers buying loans directly from CMBS lenders and acting as the issuing entity.

Exemptions from US credit risk retention requirements

Exemptions are available for qualifying non-US securitisations as well as for securitisation transactions collateralised by residential mortgages, pass-through resecuritisations or seasoned loans that meet specified criteria.

Safe harbour for non-US transactions

In implementing the risk retention provisions of the Dodd-Frank Act, the federal agencies adopted a narrow "safe harbour" provision for predominantly non-US transactions. Notably, securitsation transactions involving US issuers or US sponsors are not eligible for this exemption. The implementing regulations exclude from US risk retention requirements transactions that meet all of the following conditions:

- the transaction is not required to be registered and is not registered under the US Securities Act of 1933, as amended;
- neither the sponsor nor the issuing entity is chartered, incorporated or established under US law;
- no more than 10% of the value of all classes of ABS interests in the securitisation transaction (including the retained interests) are sold or transferred to US persons or for the account or benefit of US persons; and
- no more than 25% of the assets underlying the ABS issue were acquired from a majority owned affiliates of the sponsor or issuing entity that is chartered, incorporated or organised under US law or from an unincorporated branch or office of the issuing entity that is located in the United States.

Because transfers to US persons are included in the 10% limitation for this safe harbour, some uncertainty remains about how this safe harbour will be applied in practice. In the near term, it would be prudent for market participants to seek advice regarding the availability of this safe harbour for Regulation S transactions that contemplate offshore offers to US persons.

In the absence of a substituted compliance regime, the relatively narrow scope of the foreign safe harbour provision may have a negative effect on non-US sponsors that seek US investors because they may need to satisfy risk retention requirements of two jurisdictions (their home country and the United States).

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Asset-specific exemptions

The implementing regulations provide several exemptions that are tailored for specific asset classes. For example, qualifying resecuritisations are exempt from risk retention if:

- the resulting ABS interests consist only of a single class and provides for a pass through of all principal and interest payments received on the underlying ABS interests (net of issuer expenses); and
- the underlying ABS interests were issued in compliance with US credit risk retention requirements or an applicable exemption.

The implementing rules also provide an exemption from risk retention for securitisations collateralised solely by servicing assets and seasoned loans that have not been modified since their origination or been delinquent for 30 days or more. For purposes of this exception, "seasoned loans" includes:

- residential mortgage loans that have been outstanding and performing for either: (1) the longer of five years or the period until the outstanding balance of the loan has been reduced to 25% of the original principal balance or (2) at least seven years; and
- any loan that is not a residential mortgage loan and that has been outstanding and performing for the longer of either: (1) two years; or (2) the period until the outstanding principal balance of the loan has been reduced to 33% of the original principal balance.

Similarly, auto loans that meet a specified set of conditions (including fixed interest rates, fixed interest payments, and terms and borrower debt-to-income ratios not to exceed specified maxiumums) (known as qualifying auto loans or "**QALs**") that serve as collateral in an auto loan ABS transaction are exempt from US credit risk retention requirements. Loans related to recreational vehicles, business vehicles and automobile leases are not eligible as QALs. QALs are also subject to evaluation, certification and repurchase requirements under the final rules.

An exemption is also available for CMBS transactions that are backed by qualified commercial real estate ("**QCRE**") loans that meet a specified set of conditions (including fixed interest rate, debt service coverage ratio requirements that vary by type of loan, ten-year minimum maturity, and loan-to-value ratio maximums). Interest-only loans or interest-only period loans will not qualify as QCRE loans. These loans are also subject to evaluation, certification and repurchase requirements. In addition, an exemption from US risk retention obligations is provided for securitisations involving high-quality residential mortgages. While other categories of non-US originated loans may have trouble qualifying for potentially relevant risk retention exceptions as a practical matter, "qualifying residential mortgages" are the only category of qualifying loan exception for which federal regulators have indicated that their statutory authority to implement an exception is implicitly restricted to US-originated assets.

Conclusion

The federal regulators designed the US credit risk retention requirements to incorporate a degree of flexibility to try to accommodate issuers that need to comply with both non-US and US regulatory requirements. US risk retention requirements already apply to RMBS transactions, and other types of securitisation transactions will be required to comply as of 24 December 2016. Compliance experience in the RMBS market since the effectiveness of the implementing regulations will inform approaches to risk retention structuring for the other types of ABS transactions in the future. Experience to date indicates that in practice compliance will be challenging in many asset classes.

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7. EU and US Comparative Risk Retention: can they work together?

The EU and the US both have 5% risk retention rules applicable to securitisations. Both are intended to make sure the people putting together transactions keep some "skin in the game" and both are intended to put paid to the originate-to-distribute model of securitisation. So complying with both should be simple, right? wrong. In this article, we take a comparative look at these two risk retention regimes and discuss where they work together seamlessly – and where market participants are likely to run into challenges.

Introduction

The initial introduction in 2011 of "skin in the game" requirements in the EU was under Article 122a for bank investors in securitisation transactions. Those rules were updated in the Capital Requirements Regulations ("**CRR**") in 2013 and very similar rules were subsequently rolled-out for alternative investment fund managers via regulations ("**AIFMR**") under the Alternative Investment Fund Managers Directive in 2014 and for insurers via the Solvency II Delegated Act ("**Solvency II**") in 2015. After the briefest of pauses for thought, EU policy makers have now embarked on a drive to consolidate and rationalise these rules under the Securitisation Regulation (not only in the risk retention space, but more broadly, as set out earlier in this publication).

In parallel with these developments in the EU, the US has introduced broadly similar risk retention requirements for securitisers (but not for investors) via Regulation RR, which became effective for residential mortgage-backed securities ("**RMBS**") in December 2015 and will become effective for other asset classes of asset-backed securities ("**ABS**") in December 2016.

This article seeks to provide an update on the developments in EU risk retention, the general points to note in relation to the new US risk retention rules and a high-level comparison of these regimes relevant for EU ABS issued into the US.

Europe and the Securitisation Regulation

Existing position

As anyone involved in the European securitisation industry will be aware, many of the regulations affecting securitisation have been aimed at various institutions in their capacity as investors, rather than taking the US approach of focussing solely on "securitisers". The result of that approach has been the introduction of rules on risk retention and investor due diligence (and capital, where appropriate) in the sectoral legislation of a number of different industries, including the CRR for credit institutions and investment firms, Solvency II for insurance and reinsurance undertakings and the AIFMR for alternative investment fund managers. This has been problematic because the obligations imposed under each of these regimes are worded slightly differently, often for no obvious reason. Further, the relevant regulators for investors under these regimes have been different, increasing the risk of rules theoretically meant to achieve similar goals producing differing, and potentially conflicting, requirements in practice. At this stage, market participants have become broadly comfortable that the different regimes are meant to be interpreted consistently, but the residual risk of differing requirements remains.

Securitisation Regulation

The proposed new EU risk retention rules will have a number of novel features compared to the existing CRR, AIFMR and Solvency II rules. The two principal changes are the introduction of a dual direct/indirect approach and the exclusion of certain originators from being risk retention holders. In addition to the changes that are obvious from the proposed Securitisation Regulation itself, a new set of regulatory technical standards ("**RTS**") will be required once the new regulation comes into force. These will replace the existing risk retention RTS in force under the CRR – there being none under AIFMR or under Solvency II – and may introduce further changes to the risk retention regime in addition to those described below.

Because EU risk retention rules have historically been focussed almost entirely on institutional investors, (the so-called "indirect approach") it has been on them 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) principally on investors. The flipside of this has been that EU originators, sponsors and original lenders putting together transactions have been able to ignore the EU risk retention rules if their investor base has been unregulated investors or investors outside the EU.

Under the proposed Securitisation Regulation, EU originators, sponsors and original lenders would have a direct obligation to retain the familiar 5% net

economic interest. This is in addition to the obligation on EU institutional investors to check as part of their regulatory due diligence that the retention obligation is being met. The new regulation makes clear that the retention obligation need only be fulfilled by one party and that, failing agreement for the sponsor or original lender to retain, the obligation falls on the originator. This, of course, does not remove all ambiguity, as a number of transactions will have multiple entities that would meet the definition of an "originator".

The second major change to the retention regime is that an originator entity will not be permitted to act as a retention holder where it "has been established or operates for the sole purpose of securitising exposures". This is a modification from a previous version of the new rule that suggested the test would be a "primary purpose" test, rather than a "sole purpose" test. The version eventually proposed is clearly more appropriate and workable for industry.

In addition to these two major changes, there are a number of other helpful minor changes to the regime that appear from the face of the proposed Securitisation Regulation. These include:

- the amendment of the "originator interest" retention option to reflect the existing practice that it can be used for any revolving securitisation (the previous text suggested that it was just for securitisations of revolving exposures); and
- the amendment of the rules concerning retention on a consolidated basis so that it no longer requires the exposures to have been originated by several different entities within the group.

Unfortunately, some changes hoped for by industry do not appear to have found favour with the Commission. Chief among these were the extension of retention on a consolidated basis beyond EU regulated institutions and an adaptation of the retention regime to allow it to fit more comfortably with managed CLOs.

As mentioned above, a degree of uncertainty will remain even after the new Securitisation Regulation is approved, because new RTS are required to be formulated to add more detail to the framework set out in the regulation. These RTS will need to be agreed by the European Banking Authority (the "**EBA**"), the European Securities and Markets Authority ("**ESMA**") and the European Insurance and Occupational Pensions Authority ("**EIOPA**") before being adopted by the European Commission and will apply to all institutional investors, thereby preserving the single regime across sectors that is a principal purpose of the new regime.

US risk retention under Regulation RR

While the EU was an early adopter in the risk retention field, as is typical for US regulation – and especially so for regulations that need to be jointly crafted by multiple agencies with different agendas, interests, concerns and constituencies – the US was fashionably late to the party. In October 2014, after two proposed rulemakings (and their separate comment periods) and generally keeping US securitisation market participants in limbo for a little over three years, six US regulators jointly adopted Regulation RR in order to implement the credit risk retention mandates of the Dodd-Frank Act. The basic thrust of the regulation is that a "securitiser" (or a majority owned affiliate of a "securitiser") of an asset-backed securities transaction is required to retain a portion of the credit risk of the transaction or, in certain cases, allocate all or some of that credit risk to one or more significant originators (by asset concentration) of the securitised assets. Regulation RR is focused solely on securitisers and does not provide for an indirect, investor-based approach.

Under the regulation, a "securitiser" includes a securitisation "sponsor", defined as "a person who organises and initiates a securitisation transaction by selling or transferring assets, either directly or indirectly, including through an affiliate" to an issuer. In general, we expect that the emphasis on "securitiser" in Regulation RR will broadly align with the emphasis on "originator, sponsor or original lender" in the Securitisation Regulation, but there may be cases where the regimes point to different persons as the party to retain, which will need to be reconciled in order to effect a cross-border securitisation in the EU and the US. Although for most EU transactions this is not expected to cause issues, in the more bespoke portfolio financing arena, there could be instances of a originator or original lender who is not a "sponsor" for US purposes retaining which do not meet the US rules (although the tightening of the rules around SPV retention may go some way towards aligning the EU position with that of the US).

In the event that a transaction includes multiple sponsors, the sponsors are jointly responsible for ensuring that at least one of them or one of their majority owned affiliates retains the entire required credit risk, so as to not dilute the economic risk being retained. This is also an area of potential conflict with EU rules, which are drafted on the basis that *pro rata* retention by all retainers of a given type (originator, sponsor or original lender) is the base position where there are multiple originators, sponsors or original lenders. That said, in practice

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most EU transactions fit into one of the exemptions that allows risk retention by a single entity, meaning the practical difficulties in this area should be limited.

Regulation RR provides for three "standard" methods of retention that will be available to the sponsors of most securitisation transactions, and well as a number of "special" methods for specific transaction types. Below is a summary of the standard methods and one special method (for revolving pool securitisations) that is especially relevant for EU/US cross-border securitisations.

- *Vertical*: An "eligible vertical interest" (an "**EVI**") of at least 5% of each class of securities (both those sold to investors and those retained by the sponsor or other affiliates of the sponsor).
- *Horizontal*: An "eligible horizontal residual interest" (an "**EHRI**") of at least 5% of the fair value of all securities (both those sold to investors and those retained by the sponsor or other affiliates of the sponsor), determined in accordance with US GAAP as of the closing date of the transaction; an EHRI must be a first loss piece, meaning it must have the lowest priority of payment of principal and interest.
- *Combined vertical/horizontal ("L-shaped retention")*: A combination of an EVI and an EHRI where the sum of the percentage of the fair value of the EHRI and the percentage of the EVI equals at least 5%.
- *Special method for revolving pool securitisations*: A "seller's interest" (subject to somewhat technical requirements which may not necessarily fully align with those of an "originator interests" under EU rules) of at least 5% of the outstanding balance of all securities of each series issued by the revolving securitisation structure to investors.

The test for an EHRI is based on 5% of fair value of the securities, while the test for an EVI is based on 5% of unpaid principal balance or percentage interest. In addition, the disclosure document for a transaction relying on EHRI retention requires extensive and detailed disclosure on the fair value calculation and the methodology for the calculation, including all assumptions made and the reasons for those assumptions. No comparable disclosure is required for a transaction relying on EVI retention. So while the consensus of most US securitisers is that EHRI retention is more advantageous from an economic standpoint, EVI retention is far easier to comply with. As a result, the first few transactions that came to market in the US in early 2016 relied on EVI retention principally because market participants had not yet worked their way through the calculation of fair value and/or how to adequately disclose it. However, since March 2016, a number of US transactions have come to market relying on EHRI retention, so it appears that the market (at least for RMBS) has worked its way through one of the more challenging aspects of the regulation.

Another feature of Regulation RR is that each method of retention includes opportunities for a sponsor to offset its required risk retention. For example, if a transaction includes an originator that has originated at least 20% of the securitised assets, the sponsor may allocate a portion of the required risk retention to that originator, though the sponsor will remain responsible for risk retention compliance on that transaction. In a revolving structure, a sponsor may subtract the amount held in principal accumulation account from the outstanding balance of all securities of each series issued by the revolving securitisation structure to investors and calculate the required 5% on that reduced amount (although this will not be an option for transactions that also need to comply with EU rules). Also for revolving structures, a sponsor may hold a seller's interest of less than 5% (for example, 3%) if it also holds a corresponding residual interest (for example, 2%) in each series issued by the revolving structure after the effective date of the rule that would be an EHRI if the sponsor was not also holding a subordinated seller's interest. This latter option may be especially helpful to revolving structures that include series issued both before and after the effective date of Regulation RR. However it is worth noting that such L-shaped retention is not permitted under the EU rules and will therefore not be of use in dual-compliance transactions.

In terms of the remaining EU methods of retention, both the original and re-proposed versions of Regulation RR included a "representative sample" option, but this was not included in the final rule as it was considered difficult to implement in a way that would not result in costs outweighing benefits. An option to hold a first loss piece in every individual securitised asset was never proposed.

One of the overarching concerns of Regulation RR is that the interests of the securitiser and investors should align. Therefore, a securitser's holding of credit risk should actually mean something and incentivise better transactions, since the securitiser would be bearing a portion of the credit risk traditionally shifted to investors. To that end, Regulation RR restricts the ability of the sponsor to

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hedge, finance or transfer the required credit risk during the related required retention period to any person other than a majority owned affiliate of the sponsor. For RMBS, the retention period runs for five years after closing or until the principal balance of the securitised assets has been reduced to 25% of the balance at closing, whichever is later. For all other ABS, the retention period runs for two years after closing or until the principal balance of the securitised assets has been reduced to 33% of the balance at closing, whichever is later.

During the retention period, neither the sponsor (or a majority owned affiliate holding any required credit risk) nor the issuer may engage in any hedging transactions if payments on the hedge instrument are "materially related" to the required credit risk and the hedge would limit the financial exposure of the sponsor (or such majority owned affiliate) to the required credit risk ("**Prohibited Hedging**"). Similarly, the sponsor (or any majority owned affiliate) may not pledge any required credit risk as collateral for a financing unless that financing is full recourse to the sponsor (or such majority owned affiliate).

Side-by-side comparison of EU and US risk retention

At the date of publication there are three risk retention regimes in Europe (with substantially similar requirements) and another in the US. Assuming the introduction of the Securitisation Regulation in due course, Europe will reduce its three regimes to one, however industry participants will still need to navigate the differences between Europe and the United States in cross-border transactions. In the European RMBS space this is already an issue that European sponsors are grappling with, and other asset classes that frequently use Rule 144a placements into the US will join in December this year. While approaches to these differences will of course change over time, major European market participants in the Rule 144a market have, to our knowledge, found that dual compliance is possible and what they are already doing under the CRR, AIFMR and Solvency II can work for US purposes – but, as ever, the devil is in the detail.

While this exercise will of course need to be updated for any changes to the Securitisation Regulation before it is adopted, and for the risk retention RTS when they are adopted, we expect that dual compliance will remain workable, as the table below seeks to demonstrate.

Feature	Draft Securitisation Regulation	Regulation RR	Comparative notes
Risk Retention Method			
Vertical	No change expected from the CRR, Solvency II and AIFMR regimes. The retention of no less than 5% of the nominal value of each of the tranches sold or transferred to investors.	EVI of 5% of each class securities (both sold to investors or retained).	Both the Securitisation Regulation and Regulation RR generally have the same vertical requirements and seem to be the most compatible for EU/US cross-border transactions.
Horizontal	No change expected from the CRR, Solvency II and AIFMR regimes. First loss tranche (sized at 5% of the nominal value of the securitised exposures).	EHRI of 5% of the fair value of all securities.	The European test is based on the nominal value of the underlying exposures (assets), where the US test is based on the fair value of the securities (liabilities), which may lead to a mismatch in the amount of retention required under the two regimes, even though both are notionally 5% "first loss" pieces.

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Feature	Draft Securitisation Regulation	Regulation RR	Comparative notes
Risk Retention Method			
Alternative method for revolving securitisations	No material change expected from the CRR, Solvency II and AIFMR regimes. Originator's interest of no less than 5% of nominal value of the securitised exposures.	Seller's interest of at least 5% of the outstanding balance of all securities of each series issued by the revolver to investors, subject to certain offset options more fully described above.	Again, there is an asset/liability mismatch in the tests which may cause a divergence in the calculation of the 5% under the US and EU rules. That will result in the 'lowest common denominator' approach being used for dual-compliance. The detail around the use of the 'seller share' retention method under the US deals means that detailed compliance analysis will need to be undertaken for UK master trusts to ensure they are Regulation RR compliant.
Randomly selected exposures	No change expected from the CRR, Solvency II and AIFMR regimes. Randomly selected exposures worth at least 5% of the nominal value of all securitised exposures. These are to be held outside the deal and the use of this technique is limited to pools of more than 100 exposures.	Not applicable.	This option will not be available for EU/US cross-border transactions.
First loss exposure of every exposure	No change expected from the CRR, Solvency II and AIFMR regimes. The retention of a first loss exposure of not less than 5% of every securitised exposure in the securitisation.	Not applicable.	This option will not be available for EU/US cross-border transactions.
Combined vertical/horizontal or "L-shaped" retention	No change expected from the CRR, Solvency II and AIFMR regimes. This type of retention is not permitted under European rules.	A combination of an EVI and an EHRI where the sum of the percentage of the fair value of the EHRI and the percentage of the EVI equals at least 5%.	This option will not be available for EU/US cross-border transactions, unless the retainer opts to hold vertically or horizontally in an amount that meets the 5% minimum as calculated under the relevant EU and US rules. This is clearly economically unattractive if legal requirements are the only reason to retain the risk.

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Feature	Draft Securitisation Regulation	Regulation RR	Comparative notes
Ancillary rules relating to risk retention			
Scope of transactions subject to risk retention requirement	No change from existing legislation. Deals are subject to risk retention requirements if they are "securitisations". For these purposes, "securitisation" means a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having both of the following characteristics: (a) payments in the transaction or scheme are dependent upon the performance of the exposures or pool of exposures; (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.	Risk retention is required in respect of "asset-backed securities". These are defined under the US securities laws generally as a fixed-income or other security collateralised by any type of self-liquidating financial asset that allows the holder of the security to receive payments that depend primarily on cash flow from the asset.	Under US regime, a single-tranche transaction is subject to risk retention so long as the resulting bond meets the definition of an asset-backed security. Therefore, certain structures (e.g. repackagings) that might not be securitisations under the EU regime would result in asset-backed securities under the US rules and would thus need to comply with Regulation RR, if issued into the US.
Party to retain	Originator, sponsor or original lender now under a direct obligation to retain, in addition to the obligation on EU institutional investors to check as part of their regulatory due diligence that the retention requirement is being met. No splitting of retention among types of retainer (sponsor vs. originator vs original lender), but base position is *pro rata* retention among retainers of a given type unless an exemption applies.	"Securitiser" (typically the sponsor—see below) to retain; in certain cases, sponsor may offset EVI or EHRI (or combination) by allocating a portion of the EVI or EHRI (or combination) to an originator that has originated at least 20% of the securitised assets, but sponsor will remain responsible for risk retention compliance.	The regime in the EU is now moving to the direct approach adopted in the US. In the EU, however, the obligation on institutional investors to check is still present and will continue to serve as a check and balance on the compliance by the originator, sponsor or original lender.
Originators, sponsors and original lenders vs securitiser	No change in the definitions of the institutions who are eligible retainers. A new prohibition on originators retaining where they were established solely to securitise exposures is introduced by the Securitisation Regulation.	"Securitiser" includes a securitisation "sponsor", defined as "a person who organises and initiates a securitisation transaction by selling or transferring assets, either directly or indirectly, including through an affiliate" to an issuer.	In many cases, the US and EU rules will point to the same persons as the party to retain. However, there remain subtle differences that mean in some types of transactions (e.g. managed CLOs) cross-border EU/US securitisations will be difficult.

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Feature	Draft Securitisation Regulation	Regulation RR	Comparative notes
Ancillary rules relating to risk retention			
Restrictions on dealing	There is a prohibition on credit risk mitigation or hedging in respect of the retained interest. Further detailed rules are to be developed by EBA in conjunction with ESMA and EIOPA in this respect.	No transfer of retained interest to any person other than a majority owned affiliate; no Prohibited Hedging of retained interest; no pledge of retained interest as collateral for a financing unless financing is full recourse to the sponsor or such majority owned affiliate.	It is expected that the regimes will ultimately be broadly aligned here, however the detailed rules to be developed by the European regulators will ultimately determine this from the European side and there is relatively little visibility on that for now.
Duration of retention	No change – retention is required for the full life of the transaction.	RMBS: Five years after closing or until the principal balance of the securitised assets has been reduced to 25% of the balance at closing, whichever is later (or, the life of the transaction, if shorter). Other ABS: Two years after closing or until the principal balance of the securitised assets has been reduced to 33% of the balance at closing, whichever is later (or, the life of the transaction, if shorter). Life of transaction for revolving pool securitisation relying on seller's interest retention.	For dual compliance transactions, the retention will need to be done to the potentially longer-dated EU requirements. For example, a 7-year term RMBS, under the US rules, may only need to have risk retention in place for the first 5 years (if that time is longer than the 25% "factor-down"). Under the EU regime, retention is required until the full securitisation debt is redeemed.

Conclusion

There remain areas of uncertainty about how the comparative regimes will develop, but the broad picture is relatively clear. Since the Securitisation Regulation is still at a relatively early stage, changes in the text of the regulation itself as well as the further detail to be added by regulatory technical standards once the regulation is finally in place will be important. Frequent sponsors of ABS placed to both EU institutional investors and those in the US have already had to grapple with compliance with the three current EU regimes and Regulation RR on the RMBS front. Other classes of ABS, such as those backed by credit card receivables, will join later on this year. For sponsors of ABS in the US, the implications of Regulation RR are still being felt by structurers and as further non-RMBS asset classes join the party at the end of the year further issues will inevitably come up. Overall, the industry is successfully adapting to the requirements and it appears as though these will settle with time.

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8. The EU Covered Bond Framework: towards a 29th regime?

Along with its initial CMU proposals, the EU Commission launched a consultation on a possible EU covered bond framework, contemplating the possibility of anything from no action to an eventual move to a directly legislated, EU-level covered bond regime as an alternative to the national regimes in each EU Member State. In this article, we discuss the consultation, the feedback it received and the likely outcomes of the consultation.

Introduction

The ball is back in the EU Commission's court. The Commission launched its consultation paper on a possible pan-European covered bond framework in September 2015, and closed it on January 2015. In the meantime, responses came in from a vast array of market participants from across the EU Member States. Now that these are in, and the EU Commission is considering next steps, now seems as good a time as any to assess what might be the ultimate outcome.

In doing this, it is important at the outset to consider the context in which the consultation was set up. Coming as part of the Capital Markets Union (**"CMU"**) project, it is no surprise that the key question posed by the consultation is whether further integration in the European covered bond market is desirable. Integration is, after all, the name of the game in the wider CMU project.

Having one eye on the broader goals of the CMU project helps perhaps to explain some of the questions posed, and some of theories considered, by the Commission. Certainly, the tone of the consultation paper appears to push integration a little heavy-handedly in some places. Doubtless this is partly borne out of a desire to provoke as wide-ranging a set of views as possible, but this must be in part down to the CMU project: greater integration and the creation, as far as possible, of a Europe-wide level playing field in the capital markets across the member states, of which the covered bond market is a subset.

The key questions for covered bonds are, first, how much integration and harmonisation does the market really need and; second, to the extent we do need it, what legislative form is it likely to take. Two key themes have emerged from the responses that indicate the likely direction of travel. First, as the title this article suggests, there is a caution against making wholesale changes to a regulatory framework that already works well. Secondly, the consultation and the responses it has generated have indicated an appetite for harmonisation in certain areas. And therein lies the balancing act for any new legislation: to integrate where necessary, but not to try to fix what isn't broken.

Background – is there a problem?

In its CMU Green Paper, the Commission made clear what it viewed as the fundamental problem: "capital markets today remain fragmented and are typically organised along national lines", noting as well that "the degree of financial market integration across the EU has declined since the crisis, with banks and investors retreating to home markets". Covered bonds were no exception to this perceived market fragmentation.

Thus Part I of the consultation paper analyzed this post-crisis retrenchment specifically in the covered bond markets and considered the possible causes. Noting that, pre-crisis, covered bond yields suggested a relatively homogeneous product across jurisdictions, the Commission suggested the factors that may have caused the jurisdictional fragmentation post-crisis. One of these was that the regulatory regime applicable to covered bonds was organised on national, rather than pan-European, lines.

Thus the EU Commission invited participants to consider whether there had been a possible "stigmatisation" of the covered bond markets in worst-hit Member States resulting from the specific legal regime applicable to covered bonds in them. The key question was therefore this: was the fragmentation along jurisdictional lines a function of the differing legal regimes of the individual Member States concerned? Clearly, if the answer to this question is an unequivocal yes, there is a ready-made case for directly effective harmonising legislation that would in time supersede the regimes of the individual member states.

In response to this two points can be made. First of all, the overwhelming response of the respondents to the consultation was a resounding no.
A comparison between covered bond yields and sovereign bond yields of some of the affected member states sees an almost perfect correspondence. This leads to the conclusion that the health of the sovereign was the key factor rather than any concerns over the legal regime.

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This is hardly surprising given the intrinsic link between the health of the sovereign, the health of the banking system and correspondingly the perception of sovereign support to the issuer bank.

The second point is that these same legal differences existed during the pre-crisis period when there was no such divergence in covered bond performance. As we note below, the general market view seems to be almost the opposite of the Commission's hypothesis on this point: the differences in the underlying legal regimes, and the way that the covered bond regulations have developed around them, are a key part of its historic strength.

The question is an important one, though, because the extent to which you point the finger at divergences in national supervisory regimes and national legislation as being the problem dictates the extent to which European legislation that attempts to eliminate such discrepancies will be the solution. But the responses were fairly emphatic: there is no blame to be attached to the separateness of the national regulatory regimes; and there is consequently no appetite for attempting to replace these national regimes with a pan-European one (the so-called 29th regime – one of the suggestions put forward by the EU Commission). The view of the market in the responses has been loud and clear in this respect: such a new regime would simply increase confusion and complexity.

The case for harmonisation

However, rejecting the 29th regime is not to say that some degree of greater harmonisation in the covered bond space would not be desirable, and this is why the consultation as a whole has been warmly welcomed by the market. This is because industry rumblings about harmonisation have been going on for a while, and specific analysis on this point was conducted by the EBA in its 2014 report. The EBA report explored jurisdictional divergences in the covered bond regulations of each EU member states in detail and made various recommendations as to the areas that could, potentially, benefit from harmonisation. These include the different models of supervision of covered bond issuers and programmes; divergence in terms of the eligibility criteria for the cover pool assets (e.g. in terms of valuation and LTV); differing approaches on measures to manage mismatches between cover assets and liabilities; and differing standards in terms of transparency. All of these elements are mentioned in the Commission's consultation paper. So to an extent the consultation can also be seen as the logical next step of the EBA's work. This is helpful because it provides clues as to the areas the Commission is likely to focus on in any harmonising legislation as well as an insight into where the market feels the gaps lie at the moment.

The current regulatory environment

As noted above, direct regulation of covered bonds in the EU is currently carried out entirely according to the national laws of the individual member states, not according to EU-wide rules. To the extent there can be said pan-European regulation of covered bonds, it is indirect; through the prudential treatment of covered bonds that applies as a result of, for example, the UCITS Directive, the Capital Requirements Regulation (**"CRR"**), Solvency II and the Liquidity Coverage Ratio (**"LCR"**) legislation. In this way, EU law currently prescribes criteria that covered bonds need to satisfy in order for the relevant preferential regulatory treatment to be conferred. Thus, currently, the only way that there can be said to be EU-wide legislation that defines the regulated covered bond product is in the very legislation that is supposed to set out the benefits for being so.

Because the concept of a regulated covered bond is a meaningless one without the preferential treatment (e.g. in terms of capital treatment under Article 129 of the CRR or eligibility as high quality liquid assets under the LCR) that regulated status confers, the legislation that confers the preferential treatment (primarily the UCITS Directive and the CRR) is in fact the only legislation that attempts in any way to define the product on a pan-European basis.

There could therefore be said to be a lacuna, or at the very least a degree of circularity, in the current framework. To "correct" this would require pan-European legislation that, taking into account the existing national frameworks, actually seeks to define what a European regulated covered bond is; that links the regulatory regimes (national) to the prudential one (pan-European). As the Commission puts it in the consultation paper: "it may be appropriate to go beyond the narrow scope of prudential regulation… and pursue a more ambitious reform agenda for convergence of national laws towards a truly integrated and comprehensible covered bond framework".

How would harmonisation be achieved?

As we have noted above, the most extreme legislative tool for harmonising the EU covered bond regimes, the so-called "29th regime", looks destined for the cuttings floor. The other, less extreme options suggested by the Commission include achieving harmonisation without any legislation at all – through market-led, voluntary convergence initiatives. A successful

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example of this is the transparency template developed by the European Covered Bond Council and now being adopted by some European issuers.

No doubt industry and market-led initiatives will continue to develop. However, many of the responses also indicate enthusiasm towards something more legislative in nature. Whilst there is clearly no appetite for replacing or superseding the existing national regimes, the consultation has left open the possibility of some form of pan-European legislation that seeks to fill the gap identified above; to take the unifying threads of the national regimes and define the product on the EU level, leaving the prudential regulations to do their main job of setting out the preferential treatment flowing from that status. Any such directive might well use as a starting point the current criteria set out in Article 54 of the UCITS Directive and Article 129 of the CRR.

What would any harmonising directive cover?

As to what such a directive might cover, the consultation considers a number of elements originally identified in the EBA report. These include the definition of a covered bond, the segregation of assets, the administration of the cover pool post-insolvency of the issuer, the eligibility requirements for cover pool assets (including LTV) and transparency requirements.

Clearly, there are elements of the above that are more easily codified into European legislation than others. For example, it would be easy enough to set out a new definition of a covered bond (that could replace that set out currently at Article 54 of the UCITS Directive); it would perhaps be beneficial to set out a uniform set of minimum standards for national supervisors and even cover pool monitors; and it would be no doubt welcomed by the industry to set out in law a directly applicable set of transparency standards. It may also be possible to set out a minimum set of eligibility criteria for the overcollateralisation, as well as certain eligibility criteria applicable to the cover pool assets themselves, for example in relation to LTV.

But here is where the balancing act identified above needs to be carried out. Any such harmonising directive would ultimately need to acknowledge that in many other aspects there can be no one size fits all approach. For example, the method of asset segregation is dependent on whether there exists a dedicated covered bond law that achieves this or whether the true sale method is employed. This varies from jurisdiction to jurisdiction. In addition, the question of whether the segregation of assets would be upheld in an insolvency of the bank issuer is a matter for the individual insolvency laws of each Member State; there is no European-level substantive insolvency law currently in existence or indeed on the short- to medium-term horizon. Until there is, this aspect cannot be harmonised.

Taking another example, in relation to residential mortgage deals, matters relating to the administration and enforcement of the cover pool assets will be governed by the property laws of the relevant Member State, and property laws are likely to be among the most deep-rooted national laws, with little or no prospect of EU-wide harmonisation. There may also be perceived divergences in the resolution regimes in individual member states that mean that issuers in certain jurisdictions are perceived to have greater sovereign support than in others.

Covered bond regulations in each member state have been built around existing well-established laws; indeed, that is part of the historic strength of covered bond product. Any harmonising legislation would need to tread very carefully around these fundamentals. Furthermore, on a more macro-economic level, there will remain the jurisdictional divergences that saw the post-crisis jurisdictional fragmentation in covered bond markets. The strength of the sovereign and the banking system will always and unavoidably be factors for investors. This will be the case irrespective of any harmonising legislation.

Conclusion

The EU Commission's consultation on a possible harmonising framework has been commendably broad in its scope and warmly welcomed by the market. To its great credit, it has sought to canvas as broad a range of opinion as possible from market participants. In turn, market participants have responded in their droves, providing the Commission with a vast array of views through which to sift. Given the thoroughness with which they have approached the exercise, and the amount of feedback they have gathered, it may take some time for concrete proposals to emerge.

The early signs are encouraging: the market has indicated loudly that "if it ain't broke, don't fix it", and the Commission has confirmed subsequently that no radical overhaul will be forthcoming. All the indications are that the Commission will view the harmonisation exercise as means of fixing what can be fixed and will build on the EBA analysis in this respect, while at the same time preserving the legal fundamentals that underpin each national covered bond regime and which form the bedrock of its continuing success.

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9. The Next Step in 'Step-In' Risk: the BCBS considers the position

The Basel Committee on Banking Supervision ("**BCBS**") is considering industry responses to its December 2015 consultation paper on the identification and measurement of 'step-in risk' – the risk that a bank may provide financial support to an entity, even if it is not bound to do so under a contract, if that entity experiences financial stress.

The consultation paper is the first step towards a final framework on step-in risk, which would affect a range of sectors, including securitisation. The application of step-in risk to securitisation is, obviously, to control the risk that banks will step in to support their transactions in order to protect their market reputations. What is not clear, is why step-in risk regulation is needed for securitisation, in the context of longstanding, nuanced and reasonably well-understood implicit support rules.

The consultation paper provides a 'conceptual framework' and is intended to elicit comments from the industry. A Quantitative Impact Study ("**QIS**") is being conducted in the H1 2016. Based on information obtained from both these initiatives, the BCBS will produce a final framework, although no timeframe has been given for this.

In this article, we outline the key elements of the proposed framework and highlight some of the reaction to it from the market. It is too early to say what the final framework will look like, or indeed whether the BCBS will accept the suggestion from some quarters that it should not proceed with the framework in light of the other accounting and regulatory reforms that have taken place or are planned. Clearly the outcome of the QIS will be crucial, as the proposals, should they ultimately lead to higher capital charges, could have a broad and significant impact on the financial sector and the broader economy.

Background to the proposed framework

The framework on step-in risk is part of the Financial Stability Board agenda to develop policies aimed at reducing risk in the so-called 'shadow banking' sector and, in particular, mitigating risks in banks interactions with shadow banks. Accounting and regulatory reforms have been introduced since the financial crisis which the BCBS think reduce the likelihood of a bank stepping in to provide financial support, but they conclude that the risk has not been completely eliminated. For this reason, the BCBS considers that additional work is warranted. Ironically, however, some commentators believe that the proposals will make it more likely that investors will think a bank willing to step in to support an entity, arguing that the framework gives an implied commitment to support. Having to hold capital reserves in case a bank has to step in could potentially give an investor the impression that the bank would actually step in. This, of course, is the opposite of what is intended.

Identifying step-in risk

Under the proposed framework, banks would conduct an assessment of its contractual and non-contractual commitments with unconsolidated entities in order to evaluate whether a significant step-in risk exists. The proposals apply to unconsolidated entities, specifically those entities that are outside the scope of regulatory consolidation. The proposals have been criticised for the confusing use of the concepts of 'regulatory consolidation' and 'accounting consolidation' and the requirement to focus on entities outside the scope of regulatory consolidation has caused consternation in some corners of the market, as many believe that, following the regulatory reforms that have been put in place post-crisis, there are unlikely to be a significant number of unconsolidated entities that could pose a material and systemic risk to the financial system.

As an initial step, the BCBS expects that banks should determine whether an entity should be consolidated and, if so, apply

Primary Indicators

- Full Sponsor;
  - full upfront facilities; and
  - decision-making.
- Sponsor:
  - Partial upfront facilities,
  - decision-making, and
  - majority, or only provider of facilities
- Sponsor:
  - Partial upfront facilities,
  - decision-making, and
  - where not majority or only provider of facilities.
- Sponsor:
  - Partial upfront facilities,
  - no decision-making, and
  - majority or only provider of facilities.
- Sponsor:
  - Partial upfront facilities,
  - no decision-making, and
  - where not majority or only provider of facilities.
- Sponsor:
  - Decision-maker,
  - but no upfront facilities.
- Dominant influence:
  - Capital ties > 50%, or
  - no capital ties but ability to remove and appoint board of directors or to exercise a dominant influence as a consequence of contractual, organisational or financial relations.
- Significant influence:
  - Capital ties >20% and < 50%, or
  - Has the power to exercise a significant influence over the management.
- Significant influence:
  - Capital ties < 20%, but
  - Has the power to exercise a significant influence over the management.
- External credit rating based on a bank's own rating.
- Exclusive critical services provider.

the applicable accounting and regulatory standards. If the bank concludes that an entity should not be consolidated, the bank should go on to assess whether a 'significant' step-in risk occurs. This is done with reference to primary 'step-in indicators'. When a bank's relationship with an entity meets one of the primary indicators, there is a presumption that step-in risk is present.

The presumption that there is significant step-in risk may be rebutted if the bank can successfully argue that the step-in risk has been reduced or eliminated. Secondary indicators are included in the proposed framework with the intention that they be used by supervisors in considering whether a banks' argument that a particular step-in risk has been mitigated has been successful.

As well as the existence of indicators, supervisors may use their own judgement to determine whether step-in risk is present on a case-by-case basis, such as when a bank's recovery and/or resolution plans indicate that it would safeguard particular non-owned entities.

The indicators have been criticised by the many in the market as being too broad and imprecise, and that as a result, the framework would be difficult to implement globally in a coherent manner. Many point out that, because the indicators are broad, the determination made by a bank or a regulator on whether an indicator has been met is subjective and likely to vary, leading to an inconsistent treatment of similar potential exposures. This has lead some respondents to call for a change in approach, to prohibit step-in unless there is approval from a banking supervisor or systemic risk regulator, for instance. Prudential measures could then be applied to cases where actual step-in occurs, which would be preferable to anticipating that it will take place in all circumstances.

Measuring step-in risk

Once an entity is identified as posing a step-in risk to a bank, the next step is the measure that risk and the BCBS envisage three different approaches for this – the full consolidation approach, the proportionate consolidation approach and the conversion approach. Which one is used will depend on the extent of the relationship between the bank and the entity, although the consultation paper includes a 'map', showing which approach should be used for a particular indictor. Importantly, the BCBS is still to decide whether the proposals fall within Pillar 1 and/or Pillar 2 of the Basel framework i.e. whether minimum capital requirements are necessary or whether the risk should be subject to supervisory review. There is strong consensus in the market that, if indeed the proposal is to

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Secondary Indicators

- Branding
- Purpose and the overall design of the entity structure
- Major economic dependence of the entity on the bank
- Originator incentives
- Whether the bank enjoys/assumes the majority of the risk and rewards
- Implicit recourse
- The extent of the bank's dependency on a particular market (funding source)
- Investor expectations of returns from their investments
- Composition of the investor base
- Investor ability to bear losses on their investing instruments
- Investor ability to freely dispose of their financial instruments
- Assessment of IFRS 12 disclosure
- Entity is subject to being safeguarded for its continuity of critical functions in accordance with the bank's recovery and/or resolution plans

proceed at all, the supervision of step-in risk should be under Pillar 2 and not by setting additional capital charges.

Collective rebuttals

One of the most controversial proposals is the presumption of step-in risk if an indicator is present. However, the framework contemplates that the presumption can be rebutted, either by an individual bank or collectively for a jurisdiction and provides examples of "collective rebuttals". If a supervisor is satisfied that step-in risks are mitigated by existing public policy that is enforceable by law they will not be required to apply the framework. The proposal sets out some criteria that could be used to establish a collective rebuttal e.g. if a bank has been ring-fenced or if there is existing law or regulation which prohibits banks or other financial entities from providing non-contractual support for non-balance sheet entities e.g. the US Volcker Rule prohibition on banks providing financial support.

Despite the possibility of rebuttal, however, many in the industry think that the presumption of significant step-in risk being present if one of the indictors is met is inappropriate. Many think the indicators are too broad and imprecise and that it should not be assumed that a bank will step-in in every circumstance, making the point that actual step-in might be a remote possibility, depending on the particular circumstance, especially in light of the reforms that have taken place since the financial crisis.

Asset management and funds under management

Special consideration is given to the asset management industry as the BCBS believes that step-in risk may where a bank steps-in to support unconsolidated asset managers and unconsolidated funds (e.g. where a banking group provides credit enhancement to a fund) and where a bank owns an asset manager (and therefore consolidates it) but where there are unconsolidated funds managed by the asset manager which the bank might step-in to support, 'as an exceptional measure'.

The focus on asset management is in large part due to the support given by banks to money market funds ("**MMFs**") during the financial crisis. Several respondents have pointed out that, while this did occur during the crisis, such intervention was rare and likely to be even less in the future due to the regulatory reforms on MMFs which have been introduced or which are in the pipeline, particularly in the US and the EU. In addition, respondents point to the agency nature of asset management, which results in their being no risk on the balance sheet of the asset manager, the fact that the asset management industry is highly regulated and that many of the concepts underpinning the framework, such as 'sponsor', originally introduced into the Basel framework in relation to securitisation activity, do not sit well with funds and asset management context.

Joint ventures

Special consideration is given to joint ventures where the provisional view of the BCBS is that there should be proportional consolidation e.g. 50/50 for a joint venture between two between two banks, although the BCBS is seeking views on this.

Reaction to the proposals

In total, the BCBS received 33 responses to the consultation paper from a range of stakeholders. Some respondents were supportive of the proposals, thinking it a 'sound and simple foundation' for the development of a framework to account

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for step-in risk, and even asking for additional indicators, although the majority of respondents, which were mainly from the industry, raised concerns about the direction of travel.

Chief amongst the concerns was that the proposals are a 'blunt instrument', and that applying a one-size fits all approach to step-in risk, with reference to a set of broad and sometimes unclear set of indicators, would result in an overestimation of step-in risk, and fail to take into consideration the facts and nuances of a particular situation. In some sectors of the market, this appears to be a retrograde step. In the securitisation sector for example, rules on implicit support have existed for some time, devised as risk sensitive and nuanced rules which appear to be at odds with the broad approach contemplated by the proposals. Quite apart from step-in risk being a blunt instrument, there is a question mark on why the proposal should cover securitisation at all, given that the concerns the proposal seeks to address are dealt with comprehensively by the implicit support rules which already exist.

Although the consultation paper does refer to the regulatory and accounting reforms that have taken place since the financial crisis, changes to the Basel III reforms and the Revised Securitisation Framework for example, the BCBS has concluded that "these initiatives, in aggregate, have reduced the likelihood of a bank stepping in to provide financial support but that this step-in risk might not have been completely eliminated". Some respondents felt that the BCBS has insufficiently explained where they think they deficiencies lie, especially with regards to the Pillar 2 framework, and that, in any event, the cumulative impact of the reforms are not yet known. Others believed strongly that, as a result of the accounting and regulatory reforms that have been introduced, both at a global level through changes to the Basel Framework and in individual jurisdictions such as the US through the Volcker Rule and the UK through ring-fencing legislation, that step-in risk 'is residual'. As a result, it is argued, imposing yet more prudential measures is not warranted and would likely have a negative impact on market liquidity and the broader economy. Indeed the effect of the proposals might actually be detrimental to the aims of other policy makers. If securitisations were to become more expensive, for example, banks may be deterred which would undermine attempts to revive European securitisation markets, one of the main planks on the European Union's Capital Markets Union project.

Next steps

The consultation period closed on 17 March 2016 and, at the time of writing, the BCBS has not responded to the feedback it has received. Simultaneously with the consultation, the BCBS has been conducting a Quantitative Impact Study which will run through to the middle of 2016 and the final framework will reflect the feedback received from both the QIS and the consultation. Consequently, we do not know what the final framework will look like, or when it will be introduced. Clearly the results of the QIS will be particularly important, the current proposals could have a wide ranging and high impact.

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Step-in risk: part of the shadow banking agenda

The BCBS proposals on step-in risk are in response to the FSB policy measures to address risks to financial stability caused by 'shadow banking', which it has defined as 'credit intermediation involving entities fully or partly outside the regular banking system'. The FSB has developed policies in five areas where oversight and regulation needs to be strengthened to reduce shadow banking risks, one such area being mitigating risks in banks' interaction with shadow banking entities. In this context, the BCBS was requested by the FSB to look at the scope of consolidation and, if risks have not been eliminated by measures already taken, to extend the perimeter for prudential regulation to entities which are currently unconsolidated. The step-in risk proposals are part of that exercise.

Since the FSB's November 2015 Progress Report on *Transforming Shadow Banking into Resilient Market Based Finance*, which identified 'step-in' risk as something the FSB will be focussing on in 2016, and the consultation paper itself, there have been no further indications of what the final framework will look like or when it will be introduced. The March 2016 statement from the FSB, following its plenary meeting in Tokyo, confirmed that work is continuing to implement the post crisis reforms, including efforts to reform shadow banking into resilient market-based financing. The next progress report from the FSB is expected in the Autumn and we would expect this to include an update of the work of the BCBS on step-in risk, if not the final framework.

The BCBS proposed framework on step-in risk gives special attention to asset management activities and funds under management. Asset management is also on the agenda at the next G20 Leaders Summit in Hangzhou in September 2016 and the FSB is expected to announce mid-2016 a public consultation on policy recommendations to address structural vulnerabilities from asset management activities, with the intention of finalising policy recommendations by the end of the year. It is expected that the recommendations will cover:

- funds' liquidity mismatch
- leverage within funds
- operational risk and challenges in transferring investment mandates in a stressed situation; and

securities lending activities of asset managers and funds.

The FSB also encourages authorities to consider the use of stress tests to assess the ability of funds, either individually and collectively, to meet their redemptions under stressed market conditions. Increased information on liquidity and leverage risk in the asset management sector is deemed by policy makers to be an essential tool for understanding financial stability risks across the financial system. It such measures reach fruition, it would make the likelihood of a bank having to step-in to support an asset manager even more unlikely.

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