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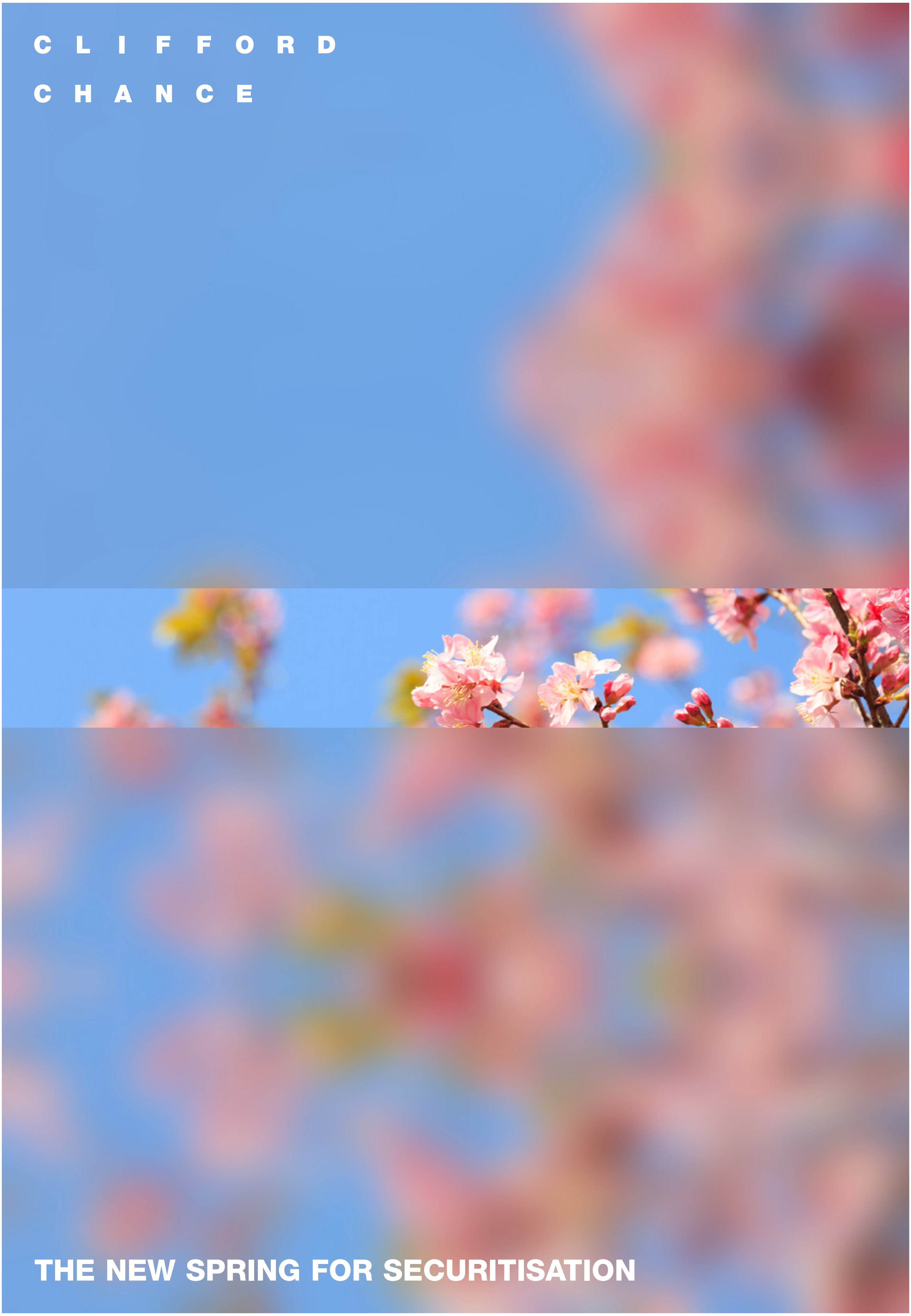

THE NEW SPRING FOR SECURITISATION

FOREWORD

This time last year it felt as though we were at an inflection point. Securitisation markets were waking up and beginning to emerge from hibernation. This warming was assisted by the reaching of political agreement on the new EU Securitisation Regulation – a major regulatory milestone to be sure – but also the surest sign yet of political consensus in favour of reviving the securitisation markets.

The revival has since begun to materialise into what looks like a new spring for securitisation. Even though the Securitisation Regulation doesn't apply until next year, there has already been a notable increase in the use of securitisation techniques, both for more traditional public securitisations and for financing portfolio acquisitions and private transactions generally. This is partly to do with the improved political environment, but also helped along by macroeconomic factors, such as improvements in global economic growth, rate rises in the United States and expected rate rises in Europe.

Nevertheless, the new spring remains delicate and there are potential obstacles that could yet halt the revival it promises. While the main text of the Securitisation Regulation is in place, very important detailed rules remain to be finalised and some important consequences of the new "simple, transparent and standardised" securitisation regime remain unclear. These need to be clarified in a way that makes securitisation investments attractive to a wide range of institutional investors. This is crucial if the Capital Markets Union project is to succeed in its goal of encouraging investors back to the markets – and enticing new ones.

The EU's slow progress when it comes to addressing third country issues, divergences in rules between the EU and the US, and of course Brexit are also potential areas of concern as the revival gathers pace. We hope the perspectives on regulatory and market issues offered in this publication help you to turn the burgeoning spring for securitisation into a thriving and fruitful summer.

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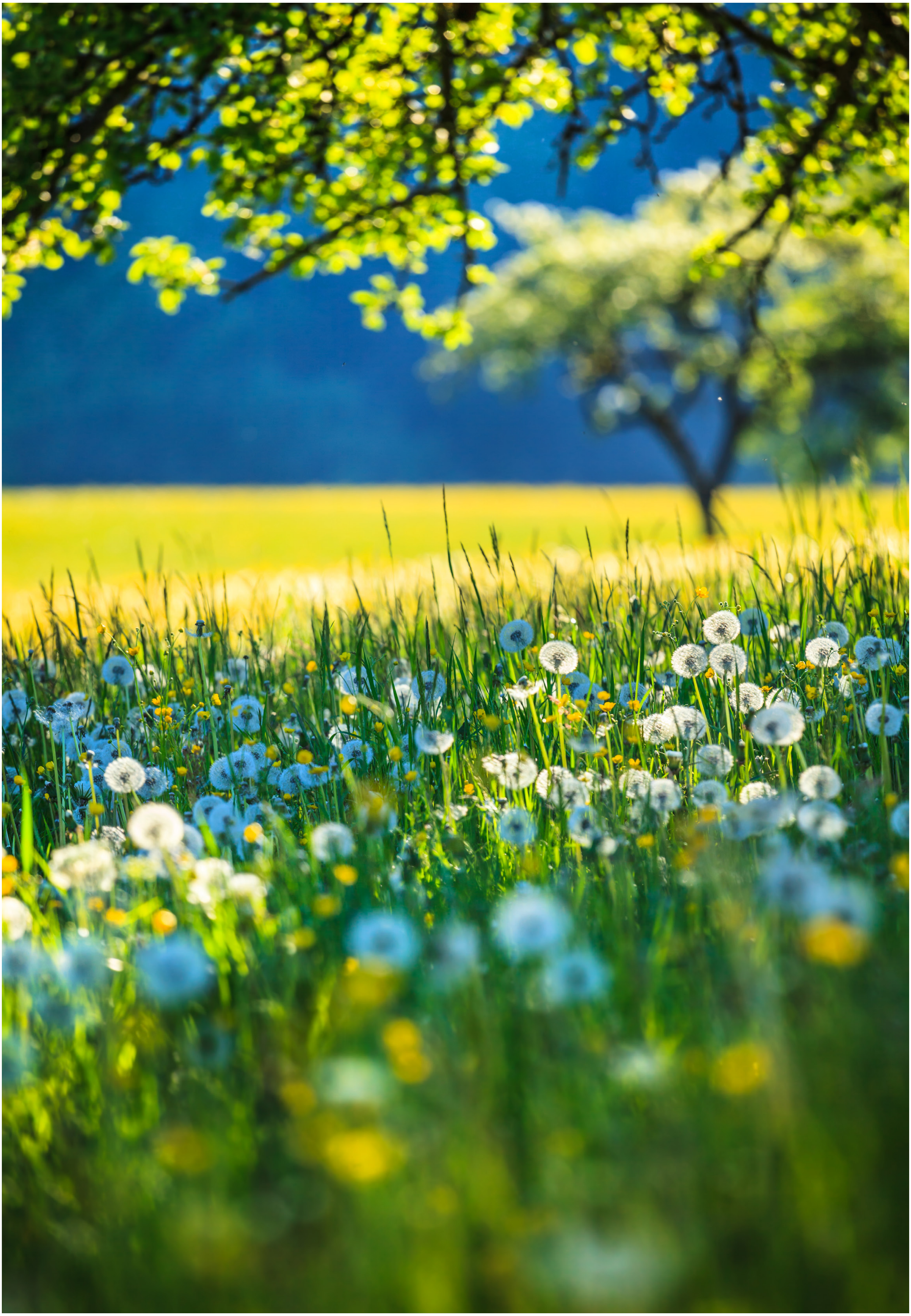


THE EU SECURITISATION REGULATION: ARRIVAL AT BASE CAMP

The European Commission proposed the Securitisation Regulation nearly three years ago. It has at times felt like a long and arduous road, but we arrived at a kind of base camp when the final regulation was published in the Official Journal of the European Union in late December 2017. We published a briefing[1] when the Securitisation Regulation was first proposed and more at several key steps along the way[2] to help clients follow the process as it developed. Now, with about 6 months before the new regime begins to apply, we take the opportunity to reflect on the final outcome of the primary legislative process and the key differences as compared to the existing regime.

As a refresher, the Securitisation Regulation – which will in general apply only to deals that issue on or after 1 January 2019 – will do two main things:

- repeal the main securitisation provisions in existing sectoral legislation applicable to banks (the Capital Requirements Regulation, or "**CRR**"), insurers (Solvency II) and fund managers (the Alternative Investment Fund Mangers Directive regime) and recast those provisions in a new, harmonised securitisation regime applicable to all institutional investors; and
- introduce a concept of "simple, transparent and standardised" (or "STS") securitisation that would receive more benign regulatory treatment than other securitisations (as to which see our article later in this publication entitled "The EU Securitisation Regulation: turning the STS dream into reality").

In addition to these two high-level changes, the Securitisation Regulation legislative package introduced a number of other significant changes. These include a ban on resecuritisation, a ban on securitising self-certified residential mortgage loans, formal restrictions on marketing securitisations to retail investors and an – apparently accidental – significant expansion in the scope of securitisation rules applicable to EU banks on a consolidated basis.

We consider each of these in more detail below.

Recast securitisation regime

The first thing the Securitisation Regulation does is to recast the main regulatory obligations associated with securitisation. Perhaps the most significant change, though, is not in the substantive content of these obligations, but in their vastly expanded scope. By virtue of the fact that securitisation rules have hitherto been part of the prudential regulation of banks, fund managers and insurers, only those regulated institutions have had to worry about them. The reach of EU securitisation rules has historically further been limited because they have largely been structured as rules on investors, so even an EU bank could escape most EU securitisation rules by marketing its transaction exclusively to non-EU investors. A large EU corporate securitising its trade receivables with either unregulated or non-EU investors would – at the moment – be subject to essentially no EU regulation aimed at securitisation.

All of this is about to change. Under the Securitisation Regulation, originators, sponsors[3] and original lenders of securitisations will, from 1 January 2019, be subject to a raft of obligations regardless of their status as regulated entities or otherwise. This is made worse by the fact that many transactions have multiple parties who could fulfil at least one definition of the term "originator" and the uncertain scope of which "originators" will be considered caught by these obligations. The obligations include a

[1] "The Proposed Securitisation Regulation" available at https://www.cliffordchance.com/briefings/2015/09/the_proposed_securitisationregulation.html

[2] "The Securitisation Regulation: where to next" in *Navigating the Tangled Forest*.

"The EU Securitisation Regulation: a light at the end of the tunnel" in *Surveying the Scene*.

"Political Agreement Reached on the Securitisation Regulation" available at https://www.cliffordchance.com/briefings/2017/06/political_agreementreachedonthesecuritisatio.html

"EU Securitisation Regulation – A sting in the tail?" available at https://www.cliffordchance.com/briefings/2017/07/eu_securitisationregulation-astinginth.html

"EU Securitisation Regulation – A Solution for Self-Certified Mortgages" available at https://www.cliffordchance.com/briefings/2017/10/eu_securitisationregulation-asolutionfo.html

[3] Sponsors will, of course, generally be regulated by their very nature, although there is an outstanding debate about whether this will continue necessarily to be regulated entities under the new definition of "sponsor".

direct risk retention obligation and extensive disclosure obligations (discussed further below, and in the next article in this publication, which covers the secondary measures being made under the Securitisation Regulation). Even though this expanded scope of regulation has clearly been on the cards since the new rules were initially proposed in September 2015, there appear to still be a number of affected market participants who are unaware of it – which may lead to some unpleasant surprises from the beginning of next year.

The due diligence obligation on investors is also expanding in scope, with pension funds and UCITS brought into the scope of securitisation rules for the first time. This is of particular concern to UCITS fund managers, who will functionally be blocked from investing in non-EU securitisations (and thereby tracking broader markets) in future unless those deals are specifically designed to meet EU regulatory obligations.

As to content, the securitisation obligations being recast can be broken down into three main categories: risk retention, transparency and due diligence. We break down the differences between the existing EU rules and the new ones for each of these categories in table format below.

Risk retention

	Current Securitisation Framework[4]	Securitisation Regulation
Nature of retention obligation	Indirect. EU regulated investors must check compliance. No direct obligation on retainer to retain, and retention obligation can be avoided where there is no need to make the deal appropriate for EU regulated investors.	Direct and indirect. One of originator, sponsor and original lender has an obligation to retain. They must agree who will hold retention, with originator the "fallback" retainer in the absence of agreement. EU regulated investors must also check compliance.
Retention rate	5%	Unchanged
Retention methods	5 accepted methods, including vertical slice, originator share, random selection, first loss (portfolio), or first loss (asset-by-asset)	Unchanged
Eligible retainers	Originator, sponsor, original lender	Originator, sponsor, original lender. "Sole purpose" originators who exclusively exist to securitise assets are now banned from being the retainer.
Adverse selection test	None, save the general CRR obligations not to engage in adverse selection.	Securitised assets should not be chosen such that they perform significantly worse than "comparable assets held on the balance sheet of the originator" over the life of the transaction (to a maximum of 4 years). Sanctions apply if they are so chosen and this is the intention of the originator.
Retention on a consolidated basis	Only for EU-regulated financial groups.	Unchanged.

[4] For these purposes, we are referring to the existing risk retention obligations under the CRR, AIFMD/AIFMR and Solvency II.

Transparency

	Current Securitisation Framework[5]	Securitisation Regulation
Source of disclosure obligations	Prospectus Directive, Transparency Directive, stock exchange rules, CRR, Solvency II, AIFMR, central bank liquidity scheme rules, as appropriate to the particular transaction.	Mainly the Securitisation Regulation. Prospectus Directive, Transparency Directive, stock exchange rules, central bank liquidity scheme rules continue to apply as appropriate.
Nature of disclosure obligations	A combination of direct (on the sell side) and indirect (on regulated investors to diligence certain specific information). Information investors required to diligence does not necessarily marry up with information sell side is required to disclose. Which disclosure/diligence obligations apply depends heavily on regulated status of originator, sponsor, original lender and investors. Depends also whether there is a public offer, whether and where the transaction is listed, and whether central bank liquidity scheme eligibility is desired. Potential to avoid most detailed/public disclosure obligations where so desired.	Direct and indirect. Direct disclosure obligations apply regardless of regulated status of originator, sponsor or issuer/SSPE. EU regulated investors required to diligence information that broadly mirrors what originator, sponsor and SSPE are required to disclose. Detailed disclosure required in all cases, although some relief is provided for private transactions (i.e. where no prospectus is required to be published under the Prospectus Directive). Securitisation Regulation disclosure obligations sufficiently detailed and onerous as to make others (bar the prospectus obligations, as to which see the Prospectus Regulation/PD3 section of our Regulatory Roundup) largely negligible.
Audience for disclosure	Depends heavily on factors listed above. Potential to avoid most detailed/public disclosure obligations where so desired.	In theory, only to investors, competent authorities and, upon request, to potential investors. In practice, private transactions may be able to stick to this, but public transactions will end up disclosing to the public at large.
Mechanism for disclosure	Depends heavily on factors listed above. Potential to restrict disclosure of information to private/specifically negotiated disclosure channels where so desired.	Public transactions must disclose to a securitisation data repository or (where none exists) on a website meeting certain prescribed standards. Private transactions do not have a prescribed mechanism for disclosure provided investors, competent authorities and, upon request, potential investors can access information.
Content that must be disclosed	Depends heavily on factors listed above. Potential to restrict disclosure of information to specifically negotiated items where so desired.	Full transaction documentation including prospectus or (where there is no prospectus) a deal summary, loan level data on all underlying assets, investor reports, reports of any significant events/material changes. Additional items such as the STS notification, a liability cash flow model and environmental data must be disclosed for STS securitisations.
Frequency of disclosure	Depends heavily on factors listed above. Potential to restrict disclosure of information to specifically negotiated items where so desired.	Full transaction documents, prospectus/deal summary and (where appropriate) STS notification and liability cash flow model before pricing. Loan level data and investor reports quarterly (or monthly for ABCP). Significant events/material changes to be reported without delay.

[5] For these purposes, we are excluding obligations under Article 8b of the Credit Rating Agencies' Regulation and the associated regulatory technical standards. Although these obligations are formally in force and have applied since 1 January 2017, they have never been capable of being complied with so they are not *de facto* applicable.

Due diligence

	Current Securitisation Framework[6]	Securitisation Regulation
Scope of diligence obligations	Credit institutions, investment firms, alternative investment fund managers, insurers and reinsurers.	As with current framework, plus pension funds, internally managed UCITS and UCITS management companies.
Specific items to be diligenced	Vary somewhat from regime to regime. Not well-matched to information otherwise required to be disclosed by the sell side. The AIFM regime requires diligence of the credits granted by the originator/sponsor generally, not just the assets securitised.	Harmonised for all types of institutional investor. Generally limits diligence to the underlying assets of the securitisation and the behaviour of the entities involved in respect of the underlying assets. New requirement to establish written procedures to monitor ongoing compliance.
Requires verification of compliance with direct disclosure obligations?	No. Requires only that the investor be able to check the specific items it must verify under the legislation.	Yes. Investors required to check that all information required to be disclosed has been disclosed, even where not otherwise relevant for diligence procedures.

Other issues

In addition to recasting the risk retention, transparency and due diligence obligations, and introducing STS, there are a number of other items in the Securitisation Regulation legislative package that are worthy of note:

- **Application on a consolidated basis:** The amendments to the CRR that accompanied the Securitisation Regulation have the (apparently unintended) effect of forcing EU-established credit institutions and investment firms to apply large parts of the Securitisation Regulation on a consolidated basis, throughout the globe. These include the risk retention, transparency and due diligence obligations discussed above as well as the ban on resecuritisation and the rules on credit granting discussed below. This represents a very significant expansion of a previously manageable rule that mainly affected diligence obligations. If not changed before 1 January 2019, this rule will force EU banks with securitisation operations (including trading activity) in third countries to make some very difficult choices about the continued viability of those operations.
- **Jurisdictional scope:** One aspect of the Securitisation Regulation that remains unclear is its jurisdictional scope. Nowhere in the text are the limits of its reach defined, which will introduce compliance uncertainty in cases where the parties might otherwise conclude they needn't comply. As a matter of practice, a number of market participants are working on the assumption that the regulation's reach is limited to parties who are subject to supervision by a competent authority designated under the Securitisation Regulation, but this is an area of significant uncertainty that it is hoped will be resolved by guidance issued by regulators in one form or another.
- **Problems for acquired portfolios:** The Securitisation Regulation carries over and expands the scope of rules on credit granting from the CRR. In particular, it requires that originators, original lenders and sponsors apply the same sound and well-defined criteria for credit granting to securitised and non-securitised exposures. This is relatively uncontroversial on its own, except that it requires that originators who are securitising an acquired portfolio check that the original lender complied with this requirement at the time the asset was created. Especially for older portfolios, this will often be difficult if not impossible for entirely legitimate reasons; the original lender may no longer exist or the records required to verify this may have been lost or destroyed – particularly if a securitisation was not contemplated at the time the assets were created or indeed when the portfolio was originally sold.
- **Ban on securitising self-certified mortgages:** The Securitisation Regulation also bans outright the securitisation of "residential loans… marketed and underwritten on the premise that the loan applicant or, where applicable, intermediaries were made aware that the information provided by the loan applicant might not be verified by the lender", better known as "self-cert mortgages". This seemed much more problematic than it ended up being, however, because loans made before the Mortgage Credit Directive (which effectively banned self-cert mortgages) came into force are grandfathered. There remains a roughly 2-year period between March 2014

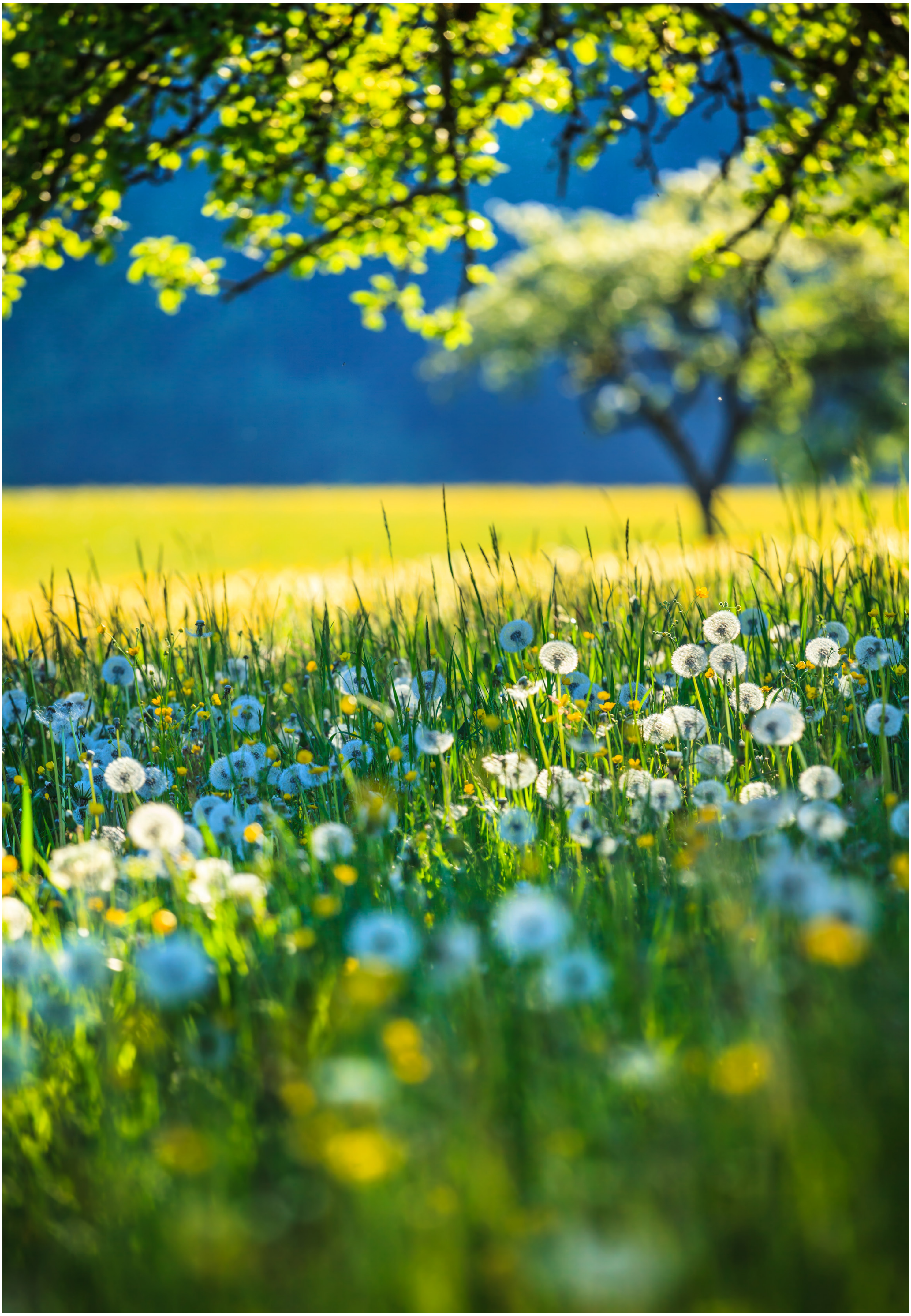
[6] For these purposes, we are considering only securitisation-specific diligence obligations

and March 2016 when it might have been possible to originate a non-grandfathered self-certified mortgage, but the number will be sufficiently small that financing them outside of a securitisation should be manageable for the market.

- **Ban on resecuritisation:** The Securitisation Regulation formally bans resecuritisations, which were anyway no longer being structured. However, the ban is problematic for a number of reasons, not least of which is that it is a ban in the abstract that doesn't purport to impose any obligations on any particular party. It says only that the "underlying exposures used in a securitisation shall not include securitisation positions", but not, e.g. that investors may not buy resecuritisations, or that originators/ sponsors may not structure them. It is therefore unclear how the ban operates and what the consequences are (and on whom) for a breach. It is also problematic because various specific instances of resecuritisations are permitted, and fully supported ABCP programmes are not considered resecuritisations "for the purposes of this [ban]", which suggests that they might be resecuritisations for other purposes – a problematic outcome if that view is taken by regulators. It remains to be seen how this will play out in practice, but this is a possible source of market friction that will need to be monitored from 1 January 2019.
- **Sanctions:** Finally, the sanctions put in place under the Securitisation Regulation are potentially very serious and may act as a disincentive for market participants to (re)join the securitisation markets, or indeed continue their involvement. These sanctions include corporate fines of up to 10% of annual net turnover, personal fines of up to EUR 5 million, public censures and bans from the market. Fortunately, there is a negligence or intentional infringement threshold before the sanctions apply, as well as a requirement to apply sanctions proportionately, both of which should offer comfort to market participants.

Conclusion

The Securitisation Regulation has been a long time in the pipeline, and industry has already had several months to begin preparations for its application. Getting the level 1 text on the books, however, is only half the journey. We've only made it to base camp on our journey to the summit of Everest. The detailed rules covering everything from disclosure obligations, to risk retention, the interpretation of the STS criteria, how an STS notification is given and much, much more are currently in development, and continued industry engagement in the formulation of those rules will be crucial to making the Securitisation Regulation a success for policymakers, regulators and industry alike.



SECONDARY MEASURES UNDER THE EU SECURITISATION REGULATION: ONWARD TO THE SUMMIT

In our previous article, we discussed the level 1 Securitisation Regulation and the changes it introduces. Before the Securitisation Regulation regime is complete, though, dozens of secondary measures will need to be put in place setting out the detail of everything from disclosure obligations, to risk retention rules, through the meaning of the STS criteria and the form of notification used to claim STS status – and much else besides. In this article we highlight a few of the important secondary measures to be made under the Securitisation Regulation and give a snapshot of their current status.

If the climb to base camp (getting the level 1 regulation in place) was a long slog, the climb from base camp to the summit (getting all the level 2 measures in place) will be an exhausting sprint. The Securitisation Regulation begins to apply from 1 January 2019 and many of the rules under that regulation are either unworkable or functionally meaningless without regulatory technical standards ("**RTS**"), implementing technical standards ("**ITS**") and guidelines to flesh out the detail. After all, a level 1 requirement to disclose loan-level data on underlying exposures isn't very meaningful without details of what data is required – and a requirement to report that data to an authorised securitisation data repository isn't going to get very far if no one knows how to apply for authorisation.

Needless to say, these secondary measures need to be put in place with all deliberate speed, and the European Supervisory Authorities ("**ESAs**") clearly know it. The European Banking Authority ("**EBA**") and the European Securities and Markets Authority ("**ESMA**") even took the very unusual step of publishing their first consultations before the Securitisation Regulation was published in the Official Journal. Given the short lead time and the dozens of mandates to draft RTS, ITS and guidelines, they will have to work hard, but the ESAs clearly won't be able to get all the secondary measures in place before the Securitisation Regulation begins to apply. They have been forced to prioritise, and have quite reasonably chosen pieces of guidance that are crucial to the basic functioning of the new framework, including secondary measures to:

- clarify the scope and content of the disclosure obligations, as well as the format and various other logistical details surrounding compliance with the disclosure obligations;
- set out the detailed rules relating to risk retention, including related areas such as adverse selection and the "sole purpose" originator test;
- help interpret the meaning of the STS criteria, including a particular RTS on the meaning of "homogeneity" for the purposes of the STS system;
- set out the form on which STS notifications are to be given;
- set out the process for being authorised as a third party verifier of STS status; and
- set out the process for being authorised as a securitisation data repository.

The consultation periods for a number of these secondary measures have come and gone and in this article we set out the principle issues raised by industry with the consultation drafts. The consultation on the guidelines for interpreting the STS criteria is – at the time of publication – still open, and will remain so until 20 July 2019[1].

Disclosure

Background

The consultation on disclosure was a unified consultation on three separate secondary measures, including two RTS and an ITS. Read together, these technical standards set out, *inter alia*:

- the scope of application of the detailed disclosure templates set out in the technical standards;
- the requirements on originators, sponsors and issuers as to what precise data needs to be disclosed, both as part of the loan-level data and as part of the investor reports – each of which needs to be provided quarterly (in the case of term securitisations) or monthly (for ABCP);
- the specific cut-off dates for providing data in quarterly/monthly loan-level data reports and investor reports;
- the format in which that data needs to be provided – ESMA are recommending XML files with the data adhering to ISO 20022 standards;
- the methods by which information is exchanged between securitisation data repositories and market participants – ESMA have recommended secure machine-to-machine connections using data encryption protocols;
- the types of data that should be available to various types of data users, including details of the way in which they should be able to query

[1] The consultation paper can be accessed here: https://www.eba.europa.eu/-/eba-consults-on-its-guidelines-interpreting-the-sts-criteria-in-securitisation

securitisation databases, the types of reports that should be available and the speed with which those queries must be addressed.

Industry concerns

In respect of the disclosure consultation, most industry focus was on the detailed disclosure templates setting out the precise line items against which disclosure will be required in both the loan-level data and the investor reports. As a general matter, it is helpful that the starting point ESMA took for these was the existing ECB reporting templates applicable in the context of its liquidity schemes. These are familiar to the market and broadly work well, thanks in part to the extensive industry consultation that went into their design.

However, a number of important changes were proposed to the templates by ESMA that were of concern to industry. The first was the addition of a number of new fields, including so-called risk-related fields that would require the disclosure of commercially sensitive information such as probabilities of default ("**PDs**") and losses given default ("**LGDs**") on an individual asset level. Other changes were also made to the existing ECB templates that would have required new data to be reported, or reported in a new way, that raised concerns about originators' ability to provide the information requested. Concerns were caused because the information might not have been collected at the point of asset creation, because there may be complex technical challenges to reporting the data in the form required (even assuming the data was collected) or because some line items simply didn't take account of the all the common deal structures in the market for the transaction type they covered.

In addition to the concerns around the reporting templates, a few of the major points raised by industry were as follows:

- **Timing of completing technical standards:** Perhaps more than with any other secondary measures, it is essential that the technical standards around disclosure are finalised quickly. This is partly because industry will inevitably need significant time to adapt to the new templates and other elements of the reporting regime once its details are finalised. It is also because the level 1 text includes a "stop-gap" rule to provide that disclosure would have to be made under the existing templates appended to the RTS made under Article 8b of the Credit Rating Agencies Regulation in the interim between 1 January 2019 and the application of the new RTS under the Securitisation Regulation. This would, of course, necessitate two successive changes of systems to adapt to new rules at great expense to industry if issuers wished to be able to issue in the interim. In an attempt to avoid this outcome, ESMA has set itself the goal of delivering its final draft technical standards by mid-July 2018 (six months ahead of the legislative deadline), and has notified the European Commission of this goal in the hopes that they will be able to facilitate a quick adoption of the technical standards that would avoid the application of the stop-gap rule at all.[2]
- **Private transactions:** In its draft technical standards, ESMA helpfully confirmed industry's interpretation of the Securitisation Regulation in respect of private transactions. That is, private transactions are still subject to all the reporting obligations set out in the level 1 text, but have greater flexibility to determine the precise content of loan-by-loan and investor reporting disclosure according to what is appropriate for the individual transaction.
- **Timing of disclosure:** There is a requirement under the Securitisation Regulation for the transaction documents, prospectus and STS notification to be provided before the pricing of the transaction. While of course the preliminary prospectus would normally be provided ahead of pricing, the other documentation would not. Industry has, accordingly, asked for clarification that providing these documents in draft would be sufficient to fulfil the obligation.
- **Data scoring and no data fields:** Finally, the draft technical standards consulted upon by ESMA broadly adopt the "no data" options and data scoring system currently used by the ECB to determine asset eligibility for their liquidity operations. While ESMA has signalled that it is open to considering a transitional period of sorts, they have made clear that the expectation is that issuers should eventually be providing 100% of the data requested. There are some concerns that this is inappropriate given the much more serious consequences of failure to comply with the Securitisation Regulation scheme (serious fines and other penalties, as opposed to ineligibility of the particular issuance for ECB liquidity operations), the volume of data required and the difficulty of obtaining (and therefore reporting) some of that data. Industry has suggested the addition of several new "no data" fields (including one for use where the data cannot be obtained because the asset is a legacy asset) and the introduction of a permanent 1% *de minimis* threshold for unavailable data reflecting a reasonable margin for good faith difficulties in providing all required data.

Risk retention

The news in general around the risk retention technical standards consulted upon by the EBA is good. The EBA has clearly sought to preserve the core of a risk retention standard it adopted only a few short years ago under the CRR and that is generally viewed as operating reasonably well. Nonetheless, a certain

[2] ESMA letter to the European Commission dated 24 April 2018 available at: https://www.esma.europa.eu/system/files_force/library/esma33-128-485_letter_to_og_timing_securitisation_disclosure_requirements.pdf.pdf?download=1

amount of change was inevitable, broadly around new elements of the risk retention rules, such as the sole purpose test and adverse selection requirements. Some highlights of industry's consultation response were as follows:

- **Agreement and disclosure:** The level 1 text of the Securitisation Regulation contains a requirement for agreement as among the originator, sponsor and original lender about who will retain, and a "back-stop" position that the originator should retain in the absence of such agreement. While the draft technical standards published by the EBA suggested disclosure of the retainer should be made in the final offering document or prospectus, it did not contain any guidance on what should happen when there is no offering document, nor did it say how the agreement as among originator, sponsor and original lender as to who would retain should be evidenced. Accordingly, industry has asked that more flexibility be provided in the place disclosure is made (to match the current regime) and to deem the disclosure of the retained interest as evidence of the required agreement as among the originator, sponsor and original lender as to who should hold the retention piece.
- **Sole purpose originators:** The Securitisation Regulation formalised an existing market position and regulatory attitude to the effect that "sole purpose" originators could not hold retention pieces. In the extreme case, this consists of an SPV being incorporated to "flip" assets into a securitisation by buying them and immediately reselling them to another securitisation vehicle. Such an SPV would meet the technical definition of an originator but it has been common ground for a number of years in the market that this doesn't fulfil the spirit of the risk retention rules. Instead, one should have an "entity of substance" acting as retainer, even if a wholly-owned SPV holds legal title on behalf of that entity of substance. The EBA's proposed test for when an entity has sufficient substance to avoid being a "sole purpose" originator was reasonably closely in line with the principles widely used in the market. The key factors to address include the presence of key elements of governance (e.g. a business strategy, decision makers appropriate to that business strategy, the existence of a broader business enterprise) and assets/resources (e.g. the capacity to meet payment obligations appropriate to the business strategy from capital, assets, or other income unrelated to the securitisation). Industry's main concern, therefore, was to preserve the flexible way in which this test is applied by industry, as opposed to the slightly more rigid formulation proposed in the draft technical standards.
- **Adverse selection:** Very late in the legislative process, penalties for adverse selection were introduced to the Securitisation Regulation as part of the risk retention rules. Perhaps consequently, there were worries around these rules, including a concern that they might inadvertently have prohibited securitisation of non-performing loans – an outcome clearly at odds with the Commission's stated policy goals. Helpfully, the EBA clarified that this was not the case in the draft RTS they consulted on – imposing only a requirement that the higher credit risk profile of the assets should be "clearly and conspicuously communicated in writing" in order to avoid sanctions for breaching the prohibition on adverse selection. There were a number of technical and drafting issues surrounding the EBA's guidance on which industry commented (including a clarification that the adverse selection rules should apply only to originators and not to sponsors), but overall the EBA's approach to this issue was very helpful.

Homogeneity

Homogeneity of a securitised portfolio is one of the criteria for a transaction to be considered "simple, transparent and standardised". Asset pool homogeneity is a concept that has been around in the markets for many years, and one that is fundamental to credit analysis. That said, it has never before been subject to formal definition, and many market participants seemed instinctively to think that a certain degree of flexibility was a good thing if only because homogeneity was difficult to define and, to quote US Supreme Court Justice Potter Stewart "[you] know it when [you] see it"[3].

Unfortunately, the Securitisation Regulation mandated an RTS to define homogeneity, a format that lends itself more easily to hard-and-fast rules than it does to principles and examples. Nonetheless, the EBA consulted on technical standards apparently designed to provide as much flexibility as possible. They started from the premise that a homogeneous pool should be characterised by assets that are similarly underwritten and serviced, and that belong to the same asset class. To that were added a long list of "risk factors" which could be used to judge whether such a similarly underwritten and serviced asset pool was in fact homogeneous. Originators were to determine the relevance of these various risk factors on a pool-by-pool basis and apply them as appropriate to generate a "homogeneous" pool.

While in theory this is a sensible approach, originators were understandably concerned that their judgments about relevance of particular risk factors might be second-guessed by competent authorities once deals were already in the market, leading to a finding that their pool was not homogeneous and their already-issued deal was therefore not STS-eligible. The principle comment from industry on the draft RTS, then, was that homogeneity had to be

[3] Stewart was, of course, describing pornography rather than asset pool homogeneity. *Jacobellis v. Ohio* 378 U.S. 184.

made more predictable at the time of structuring a transaction and – for this purpose – the originator's judgment regarding homogeneity should stand provided that judgment was reasonable. This, along with a materiality threshold (allowing there to be a small proportion of non-homogeneous assets without endangering the homogeneity of the pool overall) were the main requests from industry in order to make the homogeneity concept workable in practice.

STS Notification

The final consultation to which industry has responded already is a consultation on the format and contents of the STS notification. This again was broadly sensible, with the suggestion that there should be point-by-point explanations for how the deal met the STS criteria in the STS notification. However, in order to avoid problems with differential disclosure, the notification could draw heavily on cross-references to offering documents (where these existed for transactions) when providing these explanations.

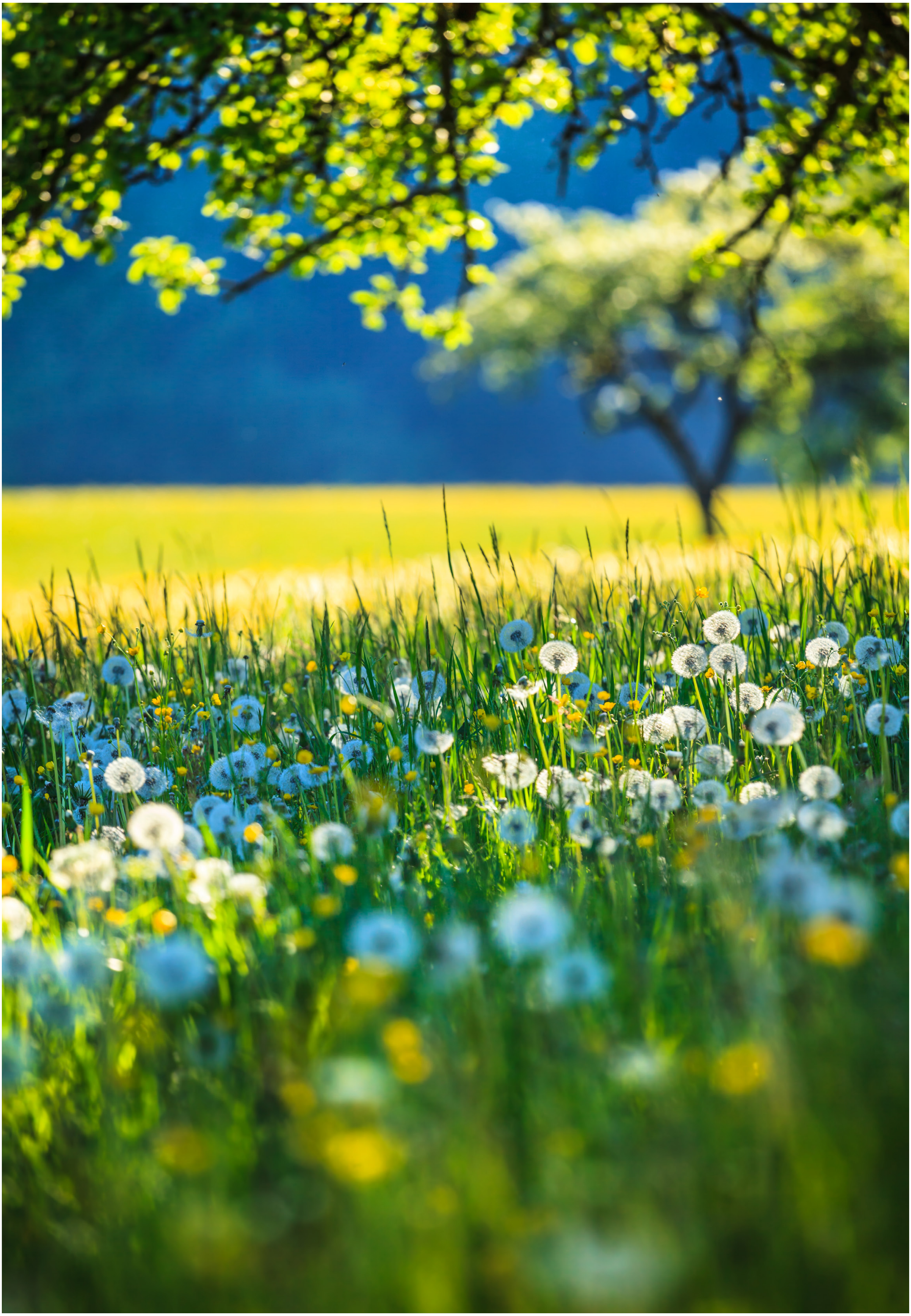
Although there were a number of more technical issues, the main substantive point of concern for industry on this consultation was the implicit suggestion that it would not be possible to give an STS notification in respect only of an ABCP transaction, independent of the ABCP programme that funded that transaction. Given the serious anticipated difficulties of achieving STS status at the ABCP programme level, this approach might lead to the irrelevance of STS for ABCP, an outcome that would be both unfortunate for the market and unpalatable to policymakers as well. This was particularly surprising given the legislative history of the Securitisation Regulation that made clear it was intended that ABCP transactions should be capable of being STS independent of the associated ABCP programme(s). It is to be hoped that positive engagement with ESMA on this point will lead to a change in direction.

Next steps

As mentioned above, the EBA is currently consulting on proposed guidelines on the interpretation of the STS criteria. While overall these proposals seem very helpful, there are a number of elements industry will likely wish to see amended, not least surrounding eligibility of assets depending on residual values for STS securitisation, the ability to change eligibility criteria for multiple issuance platforms, the requirements for disclosure around interest rate and currency risk mitigation, explicit exclusion of new asset classes from STS and some doubt around the use of standard variable rates on securitised assets. Market participants interested in the STS securitisation market are encouraged to engage with the EBA's consultation to ensure that it is as workable for the market as possible.

Conclusion

Beyond the EBA's current consultation, a number of important consultations will be issued in the coming months in the run-up to 1 January 2019 and beyond. These will cover important topics including the use of proxy data to calculate IRB inputs, the measurement of tranche maturity and the procedures for the cooperation of competent authorities. In all cases, the continued positive engagement of industry is essential to the ensure that our collective journey to the summit is a successful one.



THE EU SECURITISATION REGULATION: TURNING THE STS DREAM INTO REALITY

After a lengthy legislative process, the EU Securitisation Regulation, including the final STS criteria, was published in the Official Journal of the EU at the end of last year. Focus can now turn to how to these criteria can be met in practice – in order to obtain the label of "simple, transparent and standardised" and the benefits that come with it. This article looks at these criteria and considers what market participants can do now to ensure the STS dream can become a reality.

Why STS?

The broad aim of the Securitisation Regulation is to facilitate the recovery of the securitisation market while avoiding repeating the mistakes that triggered the financial crisis of 2007. This recovery was identified as an aim of the EU Commission's Capital Markets Union project in 2015 and is acknowledged in the recitals to the Securitisation Regulation. While not all of the operative provisions of the new legislation are ideal, the very fact that legislation seeking to encourage securitisation has been approved is helpful in itself for reviving the market.

The STS regime is the result of years of discussions among industry, regulators and policymakers going back at least as far as 2011 and it seeks to identify the transactions which legislators view as providing the benefits of securitisation while minimising the problems that led to securitisation contributing to the financial crisis. Such transactions are then encouraged in the form of more benign regulatory treatment compared to other types of securitisation, including better capital treatment and liquidity buffer eligibility for bank investors, better capital treatment for insurance company investors, and preferential treatment in respect of the clearing and margining obligations under EMIR.

STS eligibility by asset class

Low-hanging fruit

At a high level, although the STS criteria are specifically designed to avoid being asset class based, the nature of the market is to draw distinctions along these lines. Some types of transactions are clear "winners": prime RMBS, credit card receivables securitisations and auto securitisations are all in this category. Backed in general by large, granular portfolios of "real world" assets, they are some of the deals that policymakers have been keen to encourage in any case. It is not surprising, then, to find out that the STS criteria have largely been drafted to accommodate them. Assuming certain ambiguities in the criteria are resolved via the level 2 measures, there is no reason why securitisations backed by these types of assets should not be able to qualify as STS where structured appropriately. For this reason, it is likely that investors will come to expect such transactions to be STS, with non-STS transactions priced more widely than their STS counterparts.

Accordingly, efforts should already be starting to make such transactions STS. New transactions will clearly need to be structured in line with the criteria, bearing in mind the guidelines for interpretation of those criteria currently being consulted on by the EBA. Existing transactions that originators wish to "retrofit" to be STS should be carefully analysed against the STS criteria to identify whether the transaction is capable of being amended in order to comply. In particular, there are a number of criteria that are required to have been met at the time of issuance. In respect of these criteria, amending the transaction will not be sufficient to make it STS eligible. The "non-fixable" criteria include the presence of appropriate perfection triggers, appropriate eligibility criteria (which do not allow for active portfolio management on a discretionary basis), appropriate pool characteristics (including homogeneity and no exposure at issuance to credit-impaired obligors or defaulted assets), and – notably – compliance with the new risk retention rules under the Securitisation Regulation.

This last criterion is perhaps the most surprising to have in the category of "non-fixables", given that the risk

Key facts

- The STS regime will be effective from 1 January 2019, the date on which the Securitisation Regulation and CRR Amending Regulation will apply in all Member States.
- Some STS criteria will be easy to satisfy with slight changes to processes, whereas others will require new processes to be developed.
- Market participants can prepare by familiarising themselves with the criteria, identifying transactions which are capable of achieving the STS label and determining the steps necessary for such transactions to satisfy the STS criteria.
- Development of level 2 legislation is underway and has the potential for greatly assisting with the process of achieving an STS label. Industry engagement in the consultation process should further this potential.

retention rules have been changed and it would not have been possible to structure with the new rules in mind prior to late December 2017. As of mid-May 2018, the final regulatory technical standards setting out detailed risk retention rules under the Securitisation Regulation have yet to be finalised. That said, many public transactions of a type likely to be STS eligible will make use of relatively straightforward risk retention structures that are likely to comply with both the old and the new rules.

While a number of larger institutions are undertaking STS analysis internally, we expect that most originators regardless of size will – at least for their initial attempts at STS transactions – want external validation for their approach from a third party verifier of the type contemplated by Article 28 of the Securitisation Regulation. Where this is the case, it may be advisable for originators to involve their chosen third party verifier in the analysis at an early stage in order to ensure alignment of approaches and avoid disruptive disagreements later in the process.

Grey areas

For other deal types, the question of STS eligibility is less clear. For example, there are still serious concerns SME loan securitisations might fail to qualify because they exceed the concentration limits imposed as a criterion for STS bank and insurance capital purposes. The criterion on homogeneity was also a concern because of the cross-border nature of many of these deals, but following a consultation on the meaning of the homogeneity requirement, market participants are hopeful that this might be resolved. In any case, it would be unfortunate and surprising if something were not able to be worked out, not least because the Capital Markets Union project (of which the Securitisation Regulation is an important part) seeks specifically to promote access to finance for SMEs.

ABCP transactions are also subject to more difficulty than market participants had expected. As with SME CLOs, there may be challenges with the concentration limit criterion, although in ABCP transactions the challenge will normally be more one of verification than of substance since the sponsor won't be as familiar with the individual obligors as the originators will. The bigger difficulty, however, comes from the fact that ESMA appears in its consultation on STS notification to have excluded the possibility that ABCP transactions might be notified as STS separately to the programmes that fund them. This is surprising given that the level 1 text of the Securitisation Regulation was specifically changed between the Commission proposal and the final legislative text to permit exactly this. Given the difficulties with ABCP programmes qualifying as STS (as to which see below in this article), this inability to separately notify individual transactions potentially threatens the ability of any element of ABCP deals to be STS. Industry has raised this issue in response to the ESMA consultation, however, so there remains hope that this unexpected difficulty may yet be resolved.

For these in-between transactions, the value of doing the substantial analysis required to prepare for STS (especially on historic transactions) is less clear. That said, it is probably worthwhile to meet as many criteria as possible on new transactions so as to take advantage of STS where the challenges are able to be overcome.

Synthetic securitisations are also a grey area, albeit for different reasons. Synthetic transactions will not be able to satisfy the true sale criterion and so will not be STS compliant on 1 January 2019. However, this is not the end of the road for synthetics – Article 45 of the Securitisation Regulation requires the EBA, in close cooperation with ESMA and EIOPA, to publish a report on the feasibility of a specific STS framework for synthetic securitisations (limited to balance-sheet synthetic deals only). If we take Article 270 of the new CRR as a guide, any STS criteria for synthetic securitisations are likely to look very similar to the existing STS criteria for true sale securitisations. Accordingly, it may be worthwhile to meet as many of the existing STS criteria as possible so as to reduce the amount of work needed to make any transactions currently being structured STS-eligible if, as and when the STS system is made available to synthetic securitisations.

Out of reach

Other asset classes and deal types are not as favoured. Unsurprisingly, transactions backed by pools of sub-prime residential mortgages will fail to comply with the requirement that STS transactions must not have exposure to “credit impaired obligors”. EU CMBS transactions will generally have too much refinancing risk to qualify, would normally be insufficiently granular and are anyway the subject of a specific recital that makes it challenging to categorise them as STS. Managed CLOs are likewise unambiguously ineligible because of the criterion which prohibits active management of portfolios.

Surprisingly, given the amount of effort that went into designing criteria for them, ABCP programmes are highly unlikely to qualify as STS, at least at first. This is due to a combination of reasons, but the principal one is the requirement that the originator, sponsor and issuer all be established in the EU. Given the number of originators on a typical multi-seller ABCP programme and their international nature (especially the level of funding in US markets), there are few if any programmes that would even get as far as looking at the STS criteria for ABCP.

Because of the slim likelihood that these transactions will qualify as STS, it is highly questionable whether it would be worthwhile to put in the work required to bring them into compliance with any of the STS criteria.

How to obtain the STS label

The process for obtaining an STS label was the subject of much debate, with policymakers balancing the need for originators and sponsors to take responsibility for their transactions with the need to ensure the investors remained responsible for diligencing their investments, and the need for market clarity and stability on the STS status – or otherwise – of a given deal. The result is that originators and sponsors must jointly notify ESMA and their competent authority that the securitisation meets the STS criteria and such notification must contain an explanation as to how each STS criterion is satisfied (or cross refer to an explanation provided elsewhere, such as in a prospectus). There is no approval process by ESMA or any other regulatory body – instead ESMA will simply maintain a list of securitisations on its website for which it has received an STS notification. The Securitisation Regulation does however provide for the use of a third party verifier, mentioned above. Such third party verifiers will be authorised and regulated by a national competent authority and their role will be to check whether securitisations comply with the STS criteria. In order to keep responsibility with originators and sponsors, verification by a third party does not affect the liability of the originator or sponsor for the STS notification, nor does it affect the need for investors to carry out their due diligence requirements under Article 5 of the Securitisation Regulation. However, the verification of a securitisation transaction as STS may well prove helpful to market participants by providing evidence of due diligence and good faith to use as a defence against any claim that the originator or sponsor has acted negligently or intentionally submitted a false STS notification. It also provides some comfort to investors in assessing the claims of originators and sponsors that they have met the STS criteria.

Possible difficulties – and solutions

A number of difficulties arise from ambiguity. The STS criteria set out in the level 1 Securitisation Regulation include concepts which, without further guidance, may cause difficulties for practitioners seeking to verify compliance. These include various references to things needing to be done without "undue delay", a criterion excluding deals depending "predominantly" on the sale of assets securing the underlying exposures for repayment of liabilities, and risk of non-payment that is "significantly higher" than for non-securitised "comparable" exposures. These criteria are all reasonable in concept, but without further clarification, they may be too vague to be practically useful. Fortunately, the Securitisation Regulation contemplates the issuance of guidelines by the EBA to assist with interpreting the STS criteria – guidelines which are currently out for consultation and which should help to resolve a large number of the ambiguities that would otherwise be problematic. The EBA's consultation on these guidelines was published in April, with responses due by 20 July 2018. Engagement with this consultation process (and others) will be an important step in achieving much-needed clarity for the emerging STS market.

Further challenges arise out of more logistical difficulties. For example, the Securitisation Regulation contains STS criteria which refer to future events, such as a requirement to deliver the final documentation to investors within 15 days of the close of the transaction. Requiring events that can only take place in the future to be confirmed in an STS notification (which one would normally expect to deliver in advance of marketing the transaction) is an obvious impossibility and regulatory flexibility will be needed from ESMA in order to resolve such issues (e.g. by allowing STS notifications to contain an undertaking to deliver final documents within 15 days of closing).

Documentation impact

Another area in which market participants can begin preparing for the STS regime is to consider the impact of the STS regime upon their transaction documentation. There are STS criteria which impose ongoing obligations on the parties, such as the requirement to provide ongoing loan-level data and investor reports, the requirement to be risk retention-compliant and requirements as to pool composition, meaning a securitisation might lose its STS status after it is sold. Parties will almost certainly wish to allocate responsibility for maintaining STS status (and remedying any breaches) in documentation. With this responsibility will presumably go liability for failure to do so. Sufficiently detailed undertakings to maintain the STS status of the transaction given by a credible entity will presumably be key to giving investors the confidence they will need to invest.

Another relevant consideration is the standardisation provisions in the STS regime which specify certain provisions which must be included in transaction documentation. These include provisions on defaulting debtors, priority of payments, investor voting rights and investor conflicts. Contracting parties may wish to review these criteria, along with the detail provided in the EBA guidelines, and consider whether existing market standard wording meets these requirements. Where it does not, market participants may wish to begin adopting compliant wording on new transactions signed prior to the application of the STS regime, to allow new market standard wording to develop during the course of 2018 and in the interests of ongoing consistency.

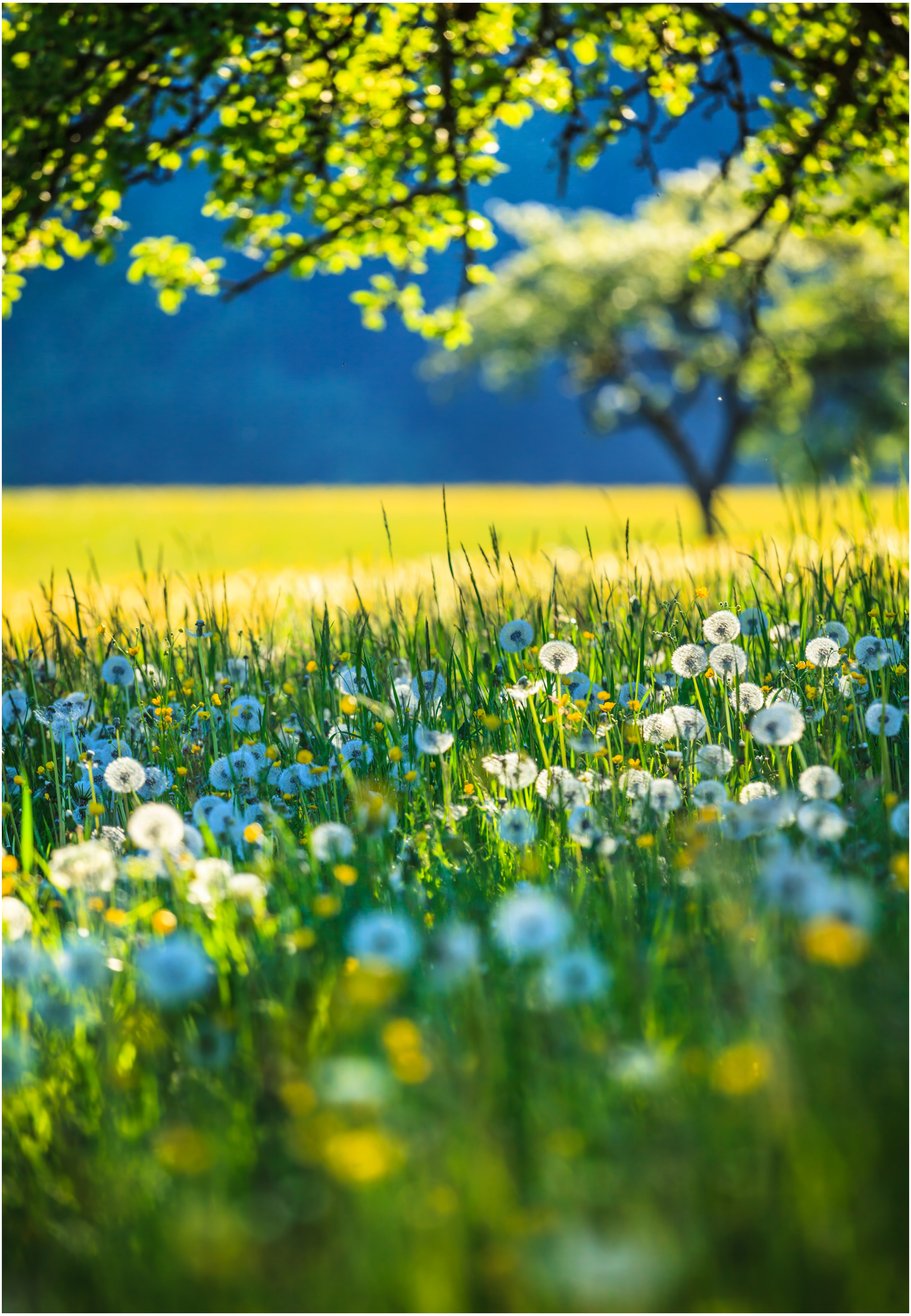
New processes

As well as preparing for changes in transaction documentation, market participants may seek to begin formulating the processes which will need to be in place in order to achieve STS compliance.

For example, one of the simplicity criteria requires the originator to have "expertise in originating exposures of a similar nature to those securitised". The draft EBA guidelines on the interpretation of the STS criteria further provide that an originator should be deemed to have the required expertise where it has originated similar exposures for at least 5 years and where certain management and senior staff have at least 5 years of relevant professional experience in the origination of such exposures. Therefore, originators may wish to put processes in place to collect such information in order to be able to demonstrate compliance.

Conclusion

Undoubtedly, a lot of work done has been undertaken in the establishment of the new STS regime. But there is still lots to do, and much of it needs to be completed before 1 January 2019. The new regulation necessitates a substantial scoping exercise for market participants – from understanding the new STS criteria, to determining which transactions can achieve an STS label, and from analysing current transactions and practices, to establishing new methods and processes. As is common, the devil is in the detail and the ease with which the STS regime can be incorporated into the securitisation market depends on there being sufficient certainty for STS notifications to be made. Market participants can facilitate this certainty by engaging in the consultation process in relation to the level 2 measures expected throughout 2018 and by working together to quickly and efficiently develop new market standard practices. Though there is much to do, the pathway exists to turn the STS concept into practical reality.



THE EU SECURITISATION REGULATION: A LUXEMBOURG PERSPECTIVE

The Securitisation Regulation is ambitious in its mission to restart the high-quality securitisation market in the EU. Because of its legislative framework and, in particular, the Luxembourg law of 22 March 2004 on securitisation (the "**Luxembourg Securitisation Law**"), Luxembourg is an established and well-regarded jurisdiction for securitisation entities and transactions. It is well equipped through its statutory securitisation framework to allow market participants to establish securitisation special purpose entities ("**SSPEs**") in Luxembourg and is expected to continue to be a friendly environment for securitisation transactions under the Securitisation Regulation.

Scope

The Luxembourg Securitisation Law contemplates and provides for a wide range of structured finance securitisations, whether not they involve the tranching of credit risk associated with an underlying asset pool. Accordingly, the Luxembourg Securitisation Law is helpful not only for transactions that are, for EU regulatory purposes, securitisations but also for other transactions that are outside the scope of the Securitisation Regulation such as repackaging transactions.

The Luxembourg Securitisation Law is extremely flexible. It permits the securitisation or repackaging of any form of risks relating to receivables, other tangible or intangible assets, or liabilities of third parties or inherent to all or part of the activities carried out by third parties. Both true sale and synthetic securitisations are possible under the Luxembourg Securitisation Law. Synthetic securitisations (including those structured as financial guarantees issued by the securitisation entity) are specifically recognised and given a clear legal basis, including shielding them from the risk of recharacterisation as insurance.

A Luxembourg securitisation vehicle is in general required to finance the acquisition of the assets it is securitising by issuing securities. The use of tranching is possible, but not required, in order to come within the ambit of the Luxembourg Securitisation Law. A securitisation vehicle may also make use of other forms of financing, subject to certain conditions. For example, temporary loan financing during the warehousing phase is permitted, as is the use of liquidity facilities. Permanent, ancillary loan financing is also possible, subject to certain conditions and restrictions. The purpose of such permanent funding may be leverage, but it can also be used for other purposes, such as to satisfy the risk retention requirements under the Securitisation Regulation.

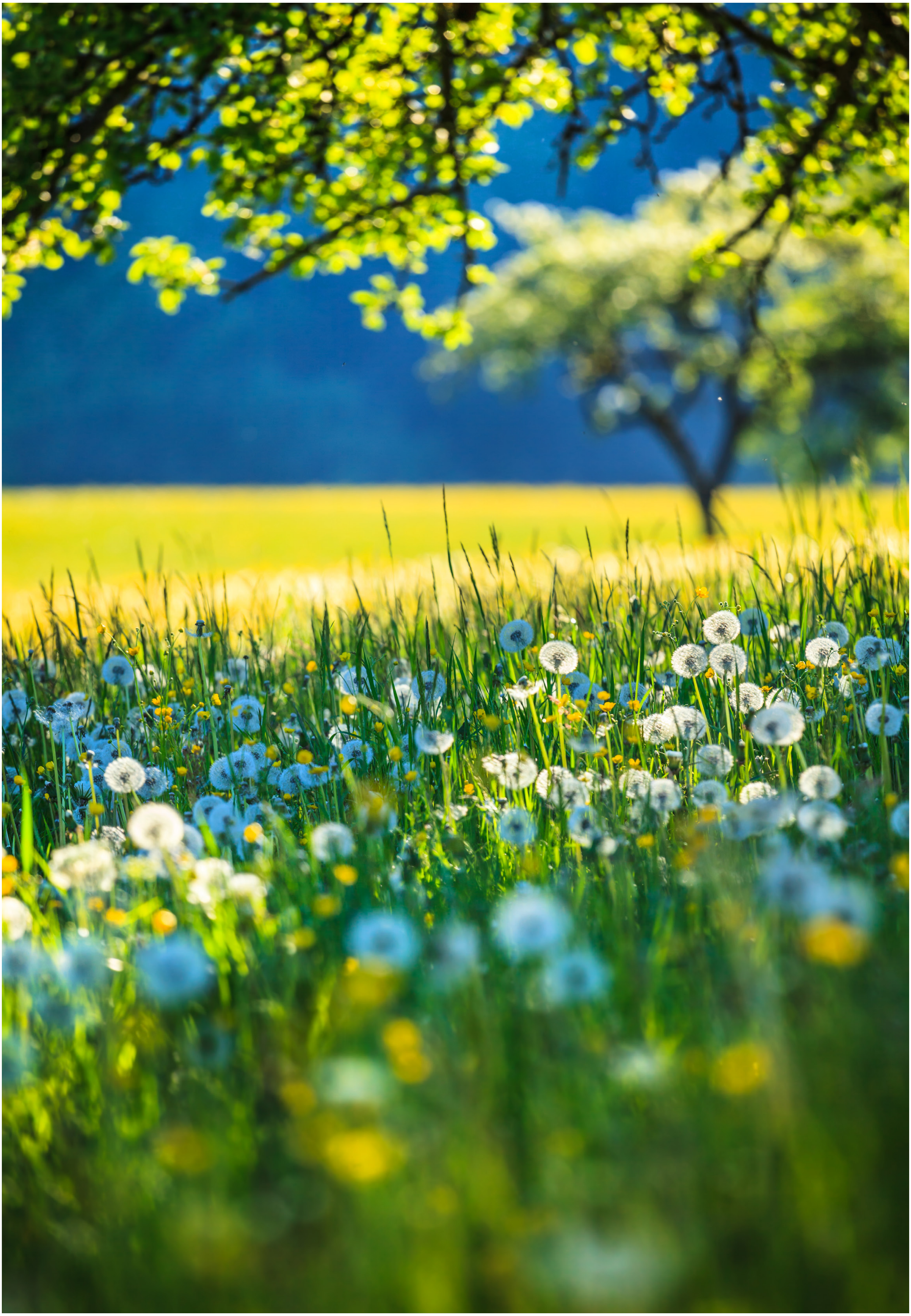
While the substantive scope of the Luxembourg Securitisation Law in many ways goes well beyond that of the Securitisation Regulation, the requirement for funding by way of issuing securities does limit the range of transactions for which SSPEs under the Luxembourg Securitisation Law can be used. Notably, an SSPE where none of the securitisation positions take the form of securities would not fall within the Luxembourg Securitisation Law. It is, however, possible to fall within the law where only some of the securitisation positions created by the SSPE are in the form of securities.

STS securitisations

The Luxembourg Securitisation Law contains provisions that are of particular interest for STS securitisation. An assignment of a claim to the securitisation vehicle takes effect between the parties and becomes enforceable against third parties at the moment of the assignment agreement, unless otherwise agreed therein. The assignment of a future claim is equally possible and automatically takes effect when the claim comes into existence. It is not required to notify the assignment of the claims to the debtor, who may however validly pay the assignor as long as he does not have knowledge of the assignment. In order to increase legal certainty, the Luxembourg Securitisation Law provides that the law of the jurisdiction where the seller is located governs the effectiveness of the transfer vis-à-vis third parties.

A Luxembourg securitisation vehicle may also enter into hedging arrangements relating to interest rate and currency risks.

The rights of the investors in a Luxembourg securitisation vehicle are strengthened by a number of legal provisions going beyond the requirements of the Securitisation Regulation or the STS regime. It expressly recognises and ensures the validity and enforceability of limited recourse, subordination and non-petition clauses, whether contracted under Luxembourg or foreign law. This enforceability remains intact in insolvency scenarios, thereby supporting the insolvency remoteness analysis. A securitisation vehicle may only dispose of its assets in accordance with its constitutional documents and, generally, it may only create an encumbrance over its assets for obligations entered into to carry out the securitisation or for the benefit of its investors. Any security granted in violation of such rule is null and void. A securitisation vehicle has a preferred claim over funds collected on its behalf by the transferor or a third party servicer prior to their insolvency.



RECENT TRENDS IN SYNTHETIC SECURITISATION

Synthetic securitisation has been no exception to the general trend of resurgent securitisation. In this article, we examine same of the causes and features of the renewed popularity of this product, as well as looking at some of the factors likely to affect the nature and extent of its future development.

Introduction

In the years since 2012, synthetic securitisation and other similar types of credit risk transfer arrangements have increased in popularity, as many banks have begun to include such transactions as part of their broader credit risk and capital management strategies. Thus, while traditional securitisation markets have been in something of a holding pattern pending the finalisation and introduction of the new STS framework synthetic securitisation has been the hot topic.

To a certain extent, the resurgent popularity of synthetic securitisation has reflected a thawing in the view taken of such transactions by regulators. While the political and regulatory perception of synthetic securitisation in the immediate aftermath of the financial crisis of 2008-09 was almost uniformly negative, in more recent years it appears that regulators at least have come to appreciate the positive role that well-structured synthetic securitisation transactions can play in a bank's credit risk and capital management programme.

2017 at a glance

2017 was the busiest year for synthetic securitisation since the financial crisis. Although it is a relatively private market, it is thought that there were approximately 30 transactions executed in 2017 (of which Clifford Chance acted on 28), not including several transactions entered into by the European Investment Fund ("**EIF**") under its SME initiative. These transactions involved more than 17 originators and over 12 jurisdictions, including of particular note, a number of transactions in the new, non-European jurisdictions of Canada and Japan.

Within Europe, the three traditional big markets of the UK, Germany and Switzerland remained the most significant markets in 2017, with the UK in particular seeing around a dozen transactions. However 2017 is particularly notable for the range of other jurisdictions represented, including Ireland, Spain, the Netherlands, Italy, France and Slovakia.

Large corporate loans remained the most significant asset class, with around 17 transactions. Perhaps surprisingly, there were relatively few SME transactions executed in the private sector market, although that partly reflects the heavy involvement of the EIF in that particular asset class. 2017 did, however, see the return of commercial real estate which had been notably absent as an asset class since 2008. It also saw activity in some of the other more specialised sectors, such as project finance, leveraged acquisition finance loans and derivative exposures, as well as increased interest in executing transactions referencing consumer loan portfolios. This follows on the back of transactions in recent years referencing other specialised asset classes such as agricultural loans and leasing exposures, as banks work through their loan books to find portfolios that lend themselves to synthetic securitisation as an effective and efficient portfolio management tool.

Early 2017 also saw the launch of the PCS Risk Transfer Label, which is intended to provide a reference standard for synthetic securitisations, similar to the True Sale PCS Label which has been present in the traditional securitisation market for a number of years.

... and into 2018

At time of writing the indications are that 2018 will be another busy year. Certainly the first quarter saw more activity than usual at this time of year, with a number of large corporate and SME transactions executed. The first quarter of 2018 also saw the execution of a number of mezzanine tranches above existing first loss transactions. Thicker protected tranche sizes are one of the expected consequences of the revisions to the CRR Securitisation Framework which will take place across the EU from the beginning of 2019, and it is therefore expected that there will be increased interest in issuing separate mezzanine tranches to achieve this.

EBA discussion paper on significant risk transfer

One of the most talked about developments in synthetic securitisation markets in 2017 and into 2018 was the EBA discussion paper on significant risk transfer, which was published in September 2017. Although this paper was not restricted to significant risk transfer in the context of synthetic securitisation, that was a major focus of the paper, and certainly was the aspect that generated the greatest market response.

Although not by any means the only reason for undertaking a synthetic securitisation, when structuring such a transaction, most originators do aim to achieve "significant risk transfer" (or SRT) for the purposes of Article 244 of the CRR, so as to be able to take advantage of the reduced risk-weightings that apply to the senior retained tranches in the securitisation. However, despite the requirements to achieve SRT being set out in Article 244 of the CRR, there has been significant variation in the application of those requirements to individual transactions in the market and, in particular, in the approach taken by regulators in different jurisdictions. There is even significant variation within the Eurozone where most banks undertaking synthetic securitisations are now regulated by joint supervision teams out of the ECB. The primary aim of the EBA discussion paper, therefore, was to attempt to achieve greater levels of consistency in the application of the SRT rules to transactions across the EU.

What was particularly interesting was the degree to which the discussion paper affected transactions in the market. Almost as soon as the paper was published, a number of originators and regulators appeared to take the view that it represented formal guidance from the EBA on the application of those rules, and accordingly that the recommendations contained therein should be applied to new transactions with immediate effect. The EBA subsequently clarified that this was not its intention. Rather, the discussion paper was intended to be just that – a vehicle to prompt discussion by communicating areas where it had identified divergences in market and regulatory practice and inviting comment as to the most appropriate ways of harmonising those areas. The discussion paper should, therefore, be seen as the beginning of that discussion, and it is possible that any formal guidance that the EBA may ultimately publish, or indeed any delegated act by the European Commission in relation to SRT, will vary significantly from the proposals set out in the discussion paper.

Market reaction

The discussion paper did, however, stimulate significant debate and discussion in the synthetic securitisation market, with many banks and market participants either submitting responses directly to the EBA or participating in a market response co-ordinated jointly by AFME and the IACPM. These responses were notable for the constructive approach taken by most originators and other market participants. While a wide variety of views were expressed, the two common themes coming through were (i) a strong preference for harmonisation and a level playing field and (ii) a desire to ensure that any eventual rules are workable and effective for the market.

Regulatory notification and approval process

One aspect of SRT which can be particularly frustrating for market participants, and for originators in particular, is the process of obtaining regulatory approval for a transaction. Indeed, there is a marked lack of consistency even as to what is *meant* by regulatory approval. In some jurisdictions, regulators will formally confirm that a transaction achieves SRT, and therefore the originator may calculate its risk-weighted exposure amounts in respect of the securitised exposures by reference to the securitisation framework rather than on an individual exposure basis. In other jurisdictions, regulators stop short of giving such approval, and merely provide a "non-objection" letter, indicating that they do not object to the bank calculating its risk-weighted exposure amounts in that way. And then there other jurisdictions in which the regulators provide no formal feedback one way or the other. Sometimes they may provide informal feedback to the originator, while in other cases it is completely up to the originator to form its own view. Even where formal feedback is obtained, the process tends to take a very long time, and is often the cause of significant delays in executing a transaction.

The ECB requires originators that are proposing to enter into a SRT transaction to notify the ECB of their intention at least three months prior to the expected closing date. However, even here, and despite the ECB having published a comprehensive list of the information to be included in that notification, there appears to be a lack of consistency as to the level of detail expected from the originator. In some cases, the relevant joint supervision team has required submission of virtually final documentation three months before closing, a requirement which is very difficult to satisfy in the context of live commercial negotiations.

In response to these disparities, the EBA has proposed a regime whereby originators would be required to notify their regulator at least one month prior to the expected closing, with the actual final documentation to be provided not later than 15 days after the closing date. The initial notification would be followed by explicit feedback from the regulator on whether or not the transaction will achieve SRT. However, the EBA has also proposed ongoing notification obligations in respect of changes to circumstances over the life of the transaction which may affect the achievement of SRT on a quarterly basis.

While the initial notification and feedback proposals were generally favourably received in the market, reaction to the ongoing reassessment proposal was less positive, with market participants expressing the view that while the achievement of SRT is a threshold question, once it has been achieved, the *effect* of that SRT may change over time as the portfolio characteristics change and the resulting risk weights applied to each tranche adjust on a dynamic basis. It should not, therefore, be necessary to reassess the threshold SRT question on an ongoing basis in the absence of an actual amendment to the transaction. Rather, once SRT has been achieved, any deterioration in the creditworthiness of the securitised portfolio or other increased risk associated with the lifecycle of the transaction should be reflected in the calculation of the risk weight applicable to each tranche in the securitisation.

Pro-rata amortisation

One of the most striking developments in the synthetic securitisation market in the last few years has been the emergence of pro-rata amortisation as the dominant form of amortisation for transactions outside the UK, where the Prudential Regulation Authority ("**PRA**") has not so far permitted an SRT transaction to include pro-rata amortisation.

Traditionally, synthetic securitisations would amortise on a sequential basis, with loan repayments being applied first to amortise the senior tranches. The effect of this, however, is to de-lever the transaction, such that the protected tranche(s) become a larger proportion of the overall securitised portfolio. The traditional justification for the sequential approach has been that while "good" exposures can be expected to prepay or refinance early, the riskier exposures are less likely to do so. Accordingly, if the protected tranche is allowed to amortise pro-rata with the overall portfolio, by the time those risky exposures eventually default, there will be insufficient protection remaining to cover the resulting losses. While this may certainly be the case for some portfolios, particularly those with lumpy exposures, this is a simplistic approach in the case of highly granular portfolios with a broad spread of repayment dates and well-established and stable historical rates of prepayment and refinancing. By monitoring the actual default rates and rates of prepayment and refinancing, and comparing those to the expected default and prepayment/refinancing rates included in the original transaction modelling, an originator is able to determine whether it is likely to need the full amount of protection, or whether it can maintain the same effective risk profile as it had at the outset while allowing the protected tranche to amortise. Should it appear that the portfolio is performing worse than expected when the transaction was entered into, SRT can be sustained by switching off pro-rata amortisation and reverting to a traditional sequential amortisation mechanic.

The EBA discussion paper has attempted to codify this analysis by proposing that pro-rata amortisation be permitted provided that four triggers are included to switch to sequential amortisation. They propose a switch to sequential amortisation if (i) cumulative losses are higher than a specified percentage of the lifetime expected losses at the outset of the transaction, (ii) cumulative non-matured defaults are higher than a specified percentage of the outstanding nominal amount of the protected tranche and any more junior tranches, (iii) the weighted average credit quality of the securitised portfolio decreases below a pre-specified level and/or the concentration of exposures classified as high risk increases above a pre-specified level or (iv) the granularity of the securitised portfolio falls below a pre-specified level. The actual levels at which these triggers would be set would be determined in conjunction with the relevant regulator on a transaction-by-transaction basis to reflect the actual risk profile of that transaction.

The EBA's proposal broadly reflects the types of triggers common in the market in recent years, although in most cases a transaction would have only one or two such triggers rather than all four proposed by the EBA. It remains to be seen whether the PRA in the UK will reconsider its approach to pro-rata amortisation in light of the EBA's proposals.

Call options

Most synthetic securitisations contain a number of call options which can be exercised by the originator in certain specified circumstances. These broadly fall into three categories: (i) regulatory calls, which can be exercised if there is a change in the applicable regulation such that the anticipated regulatory capital treatment which the originator expected to apply to the transaction no longer applies, or no longer applies in a way which is as beneficial for the originator as it had originally anticipated, (ii) clean-up calls, which can be exercised if the securitised portfolio has amortised to 10% of its initial size and (iii) time calls, which can be exercised by the originator on or following a specified date.

The first two categories, regulatory and clean-up calls, are generally not controversial, although investors will often expect that a regulatory call will not be capable of being triggered by regulatory changes which are known or anticipated at the time the transaction is entered into, such as the introduction of the new CRR Securitisation Framework from the beginning of 2020 (for transactions entered into prior to the end of 2018). The EBA has similarly expressed the view that the presence of these regulatory and clean-up calls should not hinder the achievement of SRT. However, it has proposed that regulatory calls should not extend to other factors which affect the economic efficiency of a transaction but which are not enshrined in law or regulation, such as changes to credit rating agencies' methodologies or central banks' collateral frameworks. It is not entirely clear why a change to rating agency methodology should be excluded, at least to the extent it is a reference to the methodologies that are used to ascribe a credit rating to a tranche in a securitisation where the external ratings based approach applies. Such a change essentially has a similar effect for an originator to a change to the supervisory formula (under the existing securitisation framework) or the internal ratings based approach (under the revised securitisation framework) in that it affects the risk-weights applicable to each tranche in the securitisation in a way that is beyond the originator's control. This should be distinguished from a change to the actual rating ascribed to a given tranche, which should not be seen as triggering a regulatory call.

More intriguingly, the EBA has expressly proposed that a regulatory call which is triggered by a loss of SRT in respect of the transaction (for example, as a result of the ongoing assessment of SRT referred to above) would not hinder the achievement of SRT in the first instance. In some ways this seems self-explanatory: if a transaction is entered on the basis that it achieves SRT, it should be uncontroversial from a regulatory perspective for the transaction to be callable should it subsequently fail or cease to achieve SRT. However, where such loss does not relate to a change of regulation or a change in regulatory policy, it is not clear why that should be permitted, while other changes that do not result from a change in regulation (such as a change in credit rating agency methodology) are expressly excluded.

The most controversial type of call option is the time call and, consequently, this is the area where there is the most variation between different transactions. At one extreme, in the UK, the PRA takes the view that if a time call is included, the earliest date on which that time call can be exercised should be treated as the scheduled maturity of the transaction, and thus that is the date to be used for the purpose of determining whether there is any maturity mismatch between the maturity of the transaction and the maturity of the underlying securitised exposures. This is despite the fact that Article 238 of the CRR provides that where a call option can be exercised at the discretion of the protection buyer (i.e., the originator), the earliest date on which the call option can be exercised shall only be treated as the maturity of the protection where the terms of the arrangement at origination contain a positive incentive for the institution to call the transaction at that time. Market participants have generally interpreted the reference to the "terms of the arrangement at origination" as referring to some contractual consequence of not calling the transaction, such as a step-up in the protection fee payable, rather than merely that the economics of the transaction for the originator would deteriorate if it does not exercise the call. Nevertheless, several regulators have previously expressed concerns about a market expectation that an originator will exercise a time call. In this respect, they point to the experience during the financial crisis in 2007-09 when banks did so despite not being able to issue replacement transactions at that time, with the result being a significant increase in the risk held by the banking system, despite having previously appeared to de-risked.

The EBA has proposed providing greater clarity in this regard, suggesting that a time call does not hinder achieving SRT for a synthetic securitisation if it can only be exercised at a point in time equal to or later than the weighted average life of the initial securitised portfolio or, in the case of a replenishing portfolio, the weighted average life of the securitised portfolio at the end of the replenishment period. In addition, the call should not be structured to avoid allocating losses to investors or otherwise provide credit enhancement. Although the EBA does not suggest what sorts of arrangements would have that effect, one example could be if the originator were to lose protection in respect of any defaults which had occurred prior to the exercise of the call. Market participants have not, however, reacted favourably to the EBA's proposals, noting that imposing a lengthy non-call period following the end of a replenishment period may significantly reduce the efficiency of a transaction, as well as prevent the originator from taking advantage of opportunities in the market to restructure a transaction on favourable terms. They have instead suggested that the more literal reading of the existing provisions of Article 238 of the CRR referred to above should remain applicable.

Excess spread

A feature of many pre-crisis synthetic securitisations which has been largely absent in recent years has been the use of excess spread. This is despite the fact that for some types of portfolio, particularly various consumer loan classes, the expected loss rate is often too high to be acceptable to investors without the originator being able to apply part of the excess spread on the portfolio to offset those losses.

The EBA has proposed that originators should be allowed to use excess spread in a synthetic securitisation, provided that the total amount of excess spread committed on an annual basis is less than the one year expected losses on the securitised portfolio. This excess spread is to be treated as a first loss tranche in the securitisation (and thus accorded a 1250% risk weight or one-for-one deduction from capital), and also taken into account in determining whether the amount of credit risk transferred is sufficient to achieve SRT.

Somewhat bafflingly, however, the EBA has also proposed that where excess spread is utilised, any amount of that excess spread which is allocated to the transaction in a given year but not used to cover losses in that year, should be remain available to cover future losses. Thus, assuming the excess spread allocated to the transaction each year is equal to the regulatory one year expected losses, if the portfolio performs better than that the excess spread tranche will continue to increase, imposing a higher overall capital charge for the originator, and potentially eventually leading to the transaction no longer transferring sufficient risk to maintain SRT. To avoid just such an outcome, the few transactions which have in recent years included made use of excess spread have taken a "use it or lose it" approach, where if the excess spread in a given period is greater than the losses in that period, that excess is not carried forward to cover future losses, and most market participants have taken the view that this is a more appropriate approach to take to the use of excess spread.

Finally, the EBA has also indicated that it is giving further consideration to whether originators should be required to hold capital against future excess spread, although it has not suggested how this would apply in practice. If implemented, this would significantly reduce the regulatory capital savings achieved by the SRT transaction in the first place.

Cost of credit protection

One aspect of the EBA discussion paper which is relatively uncontroversial is its proposal that the protection fees paid under a synthetic securitisation should be contingent – that is, the amount of the fee should reduce in line with the allocation of losses to the protected tranche, and cannot be simply a fixed amount payable regardless of the losses. Fixed, or guaranteed, fees have not been a feature of the synthetic securitisation market since 2008. However, this restriction may be viewed less favourably by some potential protection sellers, such as insurers, who may be more used to charging a fixed premium for the life of the transaction rather than a premium which reduces as losses are incurred.

The EBA has also confirmed that, when assessing the amount of risk that is transferred in a transaction, the protection fees should be taken into account (together with any excess spread allocated to the transaction). It does not, however, elaborate on *how* the fees are to be taken into account, or at what level the fees become so significant that they are seen as reducing the amount of risk transferred. This was the subject of a Basel paper back in 2014, but has not found its way expressly into the CRR framework. Some clarity on this point would be helpful, as it is easy to see how the protection fee and excess spread can play a very similar role in a synthetic securitisation, given that both are essentially funded from the portfolio income, and the protection fee is similar to a "use it or lose it" excess spread mechanic when an investor is calculating its overall rate of return on a securitisation position or the originator is calculating the overall cost to it of entering into the transaction.

Originator insolvency

One requirement for a credit protection arrangement used in a synthetic securitisation is that the arrangement does not contain any clause which would allow the protection seller to terminate the protection in circumstances outside the direct control of the protection buyer. To avoid falling foul of this requirement, most synthetic securitisations provide only very limited termination rights for the protection seller, including payment default, change in tax law and illegality. Sometimes this may be extended to include other contractual breaches by the originator, although only where they are material and the originator has the opportunity first to remedy the breach. In the case of a change in tax law, the originator usually as has a right to gross-up any payments to the protection seller so as to avoid a termination, and thus the termination right is not seen as outside its direct control. In the case of illegality, most market participants take the view that as a party cannot be compelled to perform an illegal contract, this must also be permitted without undermining the credit protection.

However, in addition to these termination rights, most synthetic securitisations also provide that the protection seller may terminate the protection in the event of the bankruptcy or insolvency of the originator. Whether this can be said to be outside the direct control of the originator is debatable. It is likely that the inclusion of such a termination right is a hangover from the fact that synthetic securitisation originally evolved out of the credit default swap market, where termination for insolvency is a standard market term. However, such termination is accompanied by the non-defaulting party being obliged to pay any out-of-the-money mark-to-market value of the transaction to the insolvent party, a feature which is very rare in a synthetic securitisation. Thus, some regulators have taken the view that the inclusion of such a termination right in a synthetic securitisation is only permissible where the liquidator or other insolvency official does not elect to continue paying the protection fee so as to maintain the protection.

The EBA has identified this as an open issue for SRT. They note the concern that exercise of the termination right by the protection seller in these circumstances would have adverse implications for the originator's creditors by depriving it of the benefit of the protection which the originator had been relying on to justify the lower level of regulatory capital which it had been holding against the securitised portfolio. It will be interesting to see, therefore, whether the EBA ultimately does conclude that including a bankruptcy termination right would prevent a transaction from achieving SRT.

Credit events

Virtually all synthetic securitisations include an obligor's failure to pay and its bankruptcy or insolvency as credit events which entitle the originator to receive a protection payment. In addition, the majority of transactions include some form of restructuring credit event, so that a protection claim can also be made by the originator where it has agreed to a restructuring of a securitised exposure which was in financial distress in circumstances that result in the originator suffering a loss, albeit that this may not technically be the result of a payment default by the underling obligor.

These credit events reflect the requirements in Articles 215 and 216 of the CRR, as required by Article 247 of the CRR for a synthetic securitisation to achieve SRT. However, the EBA has instead proposed that to achieve SRT, a synthetic securitisation should include failure to pay, bankruptcy and restructuring, each defined at a minimum in accordance with Article 178 of the CRR. This is the section of the CRR which defines when an exposure is treated as a defaulted exposure for capital purposes. While there is a substantial degree of overlap between the two sets of definitions, the Article 178 definitions are broader in scope – in particular they include circumstances in which an obligor is considered "unlikely to pay", but has not yet actually missed a payment, something which is troubling for many investors.

It is not clear why the EBA has chosen to adopt this approach to the definition of the required credit events, although it did adopt a similar approach in its report into synthetic securitisation published in December 2015. Given that the whole point of the synthetic securitisation is that the originator is no longer calculating its risk-weighted exposure amounts in respect of the individual securitised exposures, to define the credit events by reference to the section of the CRR which deals with the classification of those exposures rather than section which expressly specifies which events should trigger payment under a credit protection arrangement seems misplaced. Further, it is difficult to see what is ultimately to be achieved by taking this approach, as unless the exposure does suffer an actual default, the originator will ultimately not suffer any loss on the exposure. Given that the protection payments in all synthetic securitisations these days work on a "realised loss" basis, this would mean the originator would need to repay any initial protection payment it may have received following the occurrence of the credit event, generally together with make-up coupon to put the parties in the position they would have been in had the initial payment not occurred. Any risk that the protection seller will not be in a position to satisfy its obligation to pay a protection payment should an actual default eventually occur is mitigated either by the fact that it has provided collateral for that obligation (in the case of a funded transaction), or by taking the counterparty risk weight of the protection seller into account in calculating the risk-weighted amount of the protected tranche (in the case of an unfunded transaction).

Commensurate transfer of credit risk

Finally, the EBA has waded into the crucial question of how to calculate whether the reduction in the risk weighted exposure amounts the originator achieves by a synthetic securitisation is justified by a commensurate transfer of credit risk to third parties. This is, perhaps, the issue which creates the greatest uncertainty for originators when seeking to execute a synthetic securitisation to achieve SRT. While the CRR does include some mechanistic tests, these are subject to an overriding regulatory discretion to disallow the recognition of SRT where this "commensurateness" requirement is not satisfied, and the idiosyncrasies of individual transactions and securitised portfolios mean that it is very difficult to compare the application of this requirement between transactions.

In response to this, the EBA has proposed two new approaches to assessing whether or not SRT has been achieved. Both approaches attempt to convert the discretionary nature of the existing commensurateness requirement into a quantitative assessment, either in addition to the existing quantitative requirements or in replacement thereof.

These proposals have generated significant feedback from market participants. The overriding theme of that feedback has been that, while they appreciate what the EBA is trying to achieve in standardising this most difficult part of the existing SRT rules, the alternatives being proposed are not sufficiently flexible to take into account the specific features of individual transactions, and run the risk of unwittingly both disqualifying some sensible transactions and permitting others that probably should be disqualified. It remains to be seen whether it is possible for the EBA to come up with an approach to this issue that provides the desired level of certainty without having these unintended consequences.

Next steps

Unfortunately, despite the relatively short comment period following the publication of the discussion paper, it appears unlikely that there will be any immediate follow-up from the EBA in the near future. Indeed, the EBA has since indicated that it is likely to be 2021 before it returns to this topic with a more substantive response.

Before then (by July 2019) the EBA is required to publish a report on the feasibility of extending the STS framework to balance-sheet synthetic securitisations, which may in turn lead to a legislative proposal to that effect from the Commission by January 2020, so it is likely that that will be the focus of more regulatory attention over the next couple of years. While the industry would likely welcome the extension of the STS regime to include synthetic securitisations, particularly given the advantageous risk-weights applied to positions in an STS synthetic securitisation, many in the market have felt that this project should run in parallel with any reforms to the SRT regime to ensure that we do not end up with STS requirements which stand in the way of sensible reforms to the SRT framework.

Challenges for 2018 and beyond

Revised securitisation framework

The most-talked challenge facing synthetic securitisation markets in the coming years is the pending introduction of the revised CRR Securitisation Framework, which will take effect for new transactions from the beginning of January 2019, and, for transactions executed prior to that time, from the beginning of January 2020.

There are two key changes in the new framework which will affect the economic viability and efficiency of synthetic securitisation. The most obvious of these is the changes to securitisation risk weights. In particular, the risk weights applicable to senior or highly-rated tranches will increase significantly. For example, the minimum rating for an externally rated tranche of a non-STS securitisation (which will include most synthetic securitisations), will increase from the current 7% to 15% (for transactions with maturity of up to one year) or 20% (for transactions with maturity of more than five years), with linear interpolation used to calculate the risk weight for maturities between one and five years. Given that the largest component of the capital an originator is required to hold against a securitised portfolio is that relating to these senior retained tranche(s), these increases will significantly reduce the regulatory capital savings that can be achieved through a synthetic securitisation.

The second key change is the replacement of the existing hierarchies for standardised and IRB portfolios with a new set of hierarchies. Of particular significance here is that for portfolios for which the originator is able to calculate K_{IRB}, the order of application between the new SEC-IRBA methodology (which replaces the existing supervisory formula) and the SEC-ERBA methodology (which replaces the existing external ratings-based approach) is reversed, albeit subject to various exceptions and qualifications. This potentially opens up the possibility for an originator to procure a rating for some mezzanine tranches of a synthetic securitisation, which may make them more attractive to traditional ABS investors, without the existence of that rating preventing the originator from being able to apply the more favourable SEC-IRBA methodology to the more senior retained tranches. Under the current securitisation framework, because the external ratings-based approach applies in priority to the supervisory formula where it is possible to infer a rating from the rating ascribed to a more junior tranche in the same securitisation, an originator could not obtain a rating for such mezzanine tranches without losing the ability to apply the supervisory formula to the retained senior tranche(s). This has had the effect of limiting the investor base for synthetic securitisations to those investors who are capable of undertaking their own financial due diligence on the securitised portfolio so as to be able to invest in an unrated tranche. As these investors generally demand a coupon which is much higher than that which would normally be attached to any tranche other than a first loss or deeply subordinated mezzanine tranche, this has also had the effect of making it very difficult for an originator separately to place such mezzanine tranches. However, obtaining a rating on those mezzanine tranches may open them up to more traditional ABS investors who are generally only able to purchase rated notes, thus enabling the originator to place those tranches at more favourable prices. As this would also reduce the thickness of the retained senior tranche(s), this may go at least some way to offsetting the reduction in the regulatory capital benefit from synthetic securitisation.

There remain many uncertainties as to the application of the new SEC-IRBA methodology. In particular, the EBA is to develop regulatory technical standards to specify further the conditions in which originators will be allowed to calculate K_{IRB} for pools of underlying exposures. Regulators also have the power to disallow an originator from applying the SEC-IRBA methodology in various circumstances, for example where the pool of underlying exposures has a high degree of internal correlation as a result of concentrated exposures to single sectors or geographical areas or where the repayment of the securitisation position is highly dependent on risk drivers not reflected in the K_{IRB} calculation. Much will therefore depend on how regulators choose to exercise these discretions.

Article 270 – STS for SME synthetic securitisations

Synthetic securitisations are currently excluded from the new STS securitisation framework for the simple reason that they do not involve a true sale of the securitised exposures. However, the revised CRR Securitisation Framework does include one exception to this in the form of Article 270, which provides that an originator institution may apply STS risk-weights in respect of the retained senior position in a synthetic securitisation provided that (i) the securitisation meets all the requirements for a STS securitisation other than the requirement for a true sale, (ii) at least 70% of the securitised exposures are exposures to SMEs within the meaning of Article 501 of the CRR, and (iii) the credit risk in the tranches not retained by the originator is transferred to either a public sector entity such as a central government or multi-lateral development bank or to institutional investors, provided that, in the later case, the credit protection is fully collateralised by cash held on deposit with the originator.

The benefit to an originator of being able to take advantage of this special treatment for SME synthetic securitisations is that the risk weights applicable to the senior retained tranche is reduced by approximately 50%, bringing them much closer to the risk weights that apply under the existing securitisation framework.

The challenge for an originator seeking to achieve this, however, is the need to comply with all of the STS criteria in the Securitisation Regulation (other than the true sale requirement), despite those criteria not having been developed with their application to synthetic securitisations in mind. While it is technically possible for a synthetic securitisation to comply with most of these criteria, doing so is likely to involve a degree of departure from previous market practice for SME synthetic securitisations, and just as complying with the new STS regime involves challenges for originators and sponsors of true sale securitisations, the same will be the case for originators and sponsors of SME synthetic securitisations. It is likely that the synthetic securitisation market will look to see how compliance with these criteria develops in the traditional securitisation market, although as SME exposures are unlikely to be among the most prevalent asset classes for traditional STS securitisation, it remains to be seen how much guidance can be gleaned from that experience. Nevertheless, the resulting capital benefit from being able to structure a SME synthetic securitisation to meet the requirements of Article 270 is likely to encourage originators to make the effort to do so.

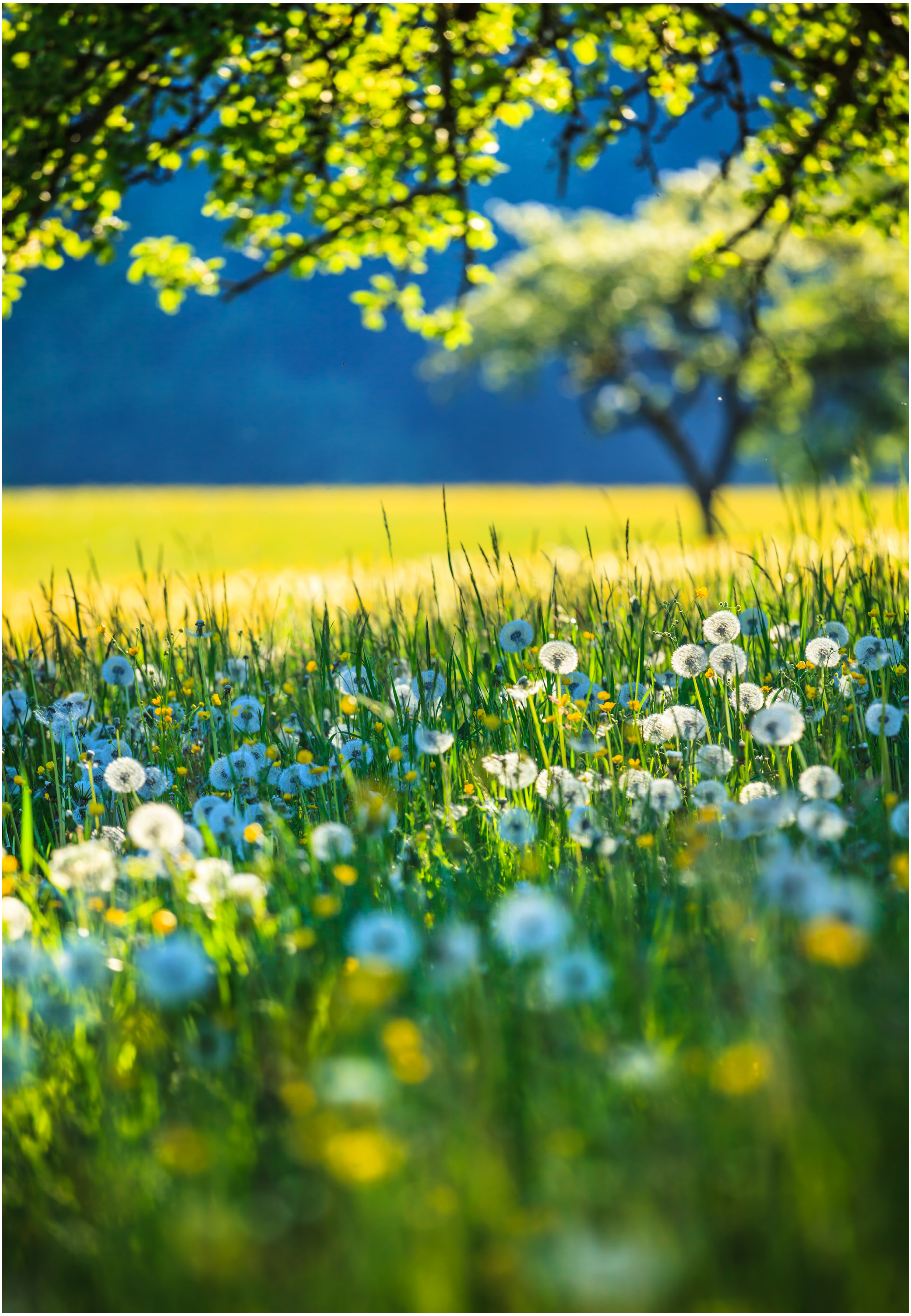
Securitisation Regulation

While synthetic securitisation is generally excluded from the scope of the STS framework, the rest of the Securitisation Regulation will apply to synthetic securitisations in the same way as it applies to traditional securitisations. In particular, the transparency requirements in Article 7 of the Securitisation Regulation will require originators and sponsors of synthetic securitisations to make information about the securitisation, including detailed information about the underlying securitised exposures, available to investors and potential investors in the securitisation and to competent authorities. It is currently unclear exactly to what extent those obligations will apply to synthetic securitisations.

The synthetic securitisation market has traditionally been a comparatively private market compared with traditional securitisation markets. Bilateral transactions are generally entirely confidential, and even in the case of a full synthetic securitisation involving an SPV note issuer, unless the transaction is listed on a regulated market such as the main market of the Irish Stock Exchange, there is generally very little information about the transaction available in the public domain.

The private nature of this market is likely to mean that some of the more onerous disclosure and transparency obligations in the Securitisation Regulation – namely the requirement to make information publicly available by means of a securitisation repository – will not apply to synthetic securitisations, as they only apply to securitisations for which a prospectus is required to be drawn up under the Prospectus Directive. As very few synthetic securitisations are now listed on a regulated market in the EU this means that these requirements will apply to very few synthetic securitisations.

Nevertheless, this does not relieve the originator, sponsors and issuer from the obligation to make information about the transaction available to investors, potential investors and competent authorities. In the case of primary issuance, this is unlikely to have much impact, as for a privately placed transaction the pool of investors and potential investors is likely to be much the same as those investors who would currently receive this information anyway. However, in the case of a full synthetic securitisation involving the issue of credit-linked notes cleared through the clearing systems, the difficulty of imposing effective transfer restrictions, or indeed the likelihood that imposing such transfer restrictions would be unacceptable to many investors, means that the pool of potential investors in the secondary market is extremely broad, and could include many potential investors who were deliberately excluded by the originator or sponsor in the primary issuance process.



THE ANTI-MONEY LAUNDERING DIRECTIVE: TRUSTEE ISSUES

EU anti-money laundering legislation is familiar territory for many market participants, but recent developments requiring trustees to identify, record and (in some cases) report to the authorities on the "beneficial owners" of trusts (a broad term that includes settlors, beneficiaries and trustees, among others) have been causing serious consternation among trustees. As this article examines, these issues are set to become even more serious with the introduction of a fifth anti-money laundering directive.

The EU has co-ordinated its efforts to tackle money laundering and financing of terrorist organisations through the Anti-Money Laundering Directive ("**AMLD**"), first adopted in 1991. AMLD requires banks and other businesses handling financial transactions (so-called "obliged entities") to apply due diligence to their customers and report suspicious activity to the authorities. AMLD has not historically been a focus of significant attention for trustees, but in 2013 the European Commission published proposals for a fourth Anti-Money Laundering Directive ("**AMLD4**") which included provisions relating to trusts, beneficial ownership and trusteeships. These provisions had implications for many transactions in the financial markets which use trusts such as eurobonds, secured loans and securitisations, for example.

Trusts as a means of dividing legal and beneficial ownership interests in assets have their origins in English common law. Over time, English and other common law systems have developed and refined the use of trusts and some civil law jurisdictions have introduced laws or devices which seek to emulate the effects of a trust. As a result, trusts can arise in a very wide array of circumstances, including where parties who may be the beneficiaries of a trust are unaware of their entitlement or the trustee of the trust may be unaware of the specific identity of individual beneficiaries.

This lack of certainty around the identity of the beneficiaries of a trust has spawned suspicion in certain quarters that trusts may be used for nefarious purposes, including the reduction, or even eradication, of tax obligations. So it is perhaps inevitable that trusts have also come under scrutiny as vehicles for potential money laundering activity and that AMLD4 would attempt to address these concerns.

The initial draft of AMLD4 required trustees to identify all trusts for which they were responsible and to identify all the beneficial owners of those trusts in publicly available registers which would allow law enforcement agencies and regulators to monitor whether the trusts were being used to launder the proceeds of unlawful activities, enabling them to take enforcement action where necessary. A consultation process launched in the UK identified concerns from a number of interested parties, among them professional trustees of financial markets instruments, who lobbied to have the scale and implications of this provision – Article 31 – reconsidered. When AMLD4 eventually came into force, the position under Article 31 was improved. The key requirements for trusts under Article 31 may be summarised as follows:

1. Member States must require that trustees of any express trust governed under their law obtain and hold adequate, accurate and up-to-date information on beneficial ownership regarding the trust.
2. Member States must require that the information referred to in paragraph 1 is held in a central register *when the trust generates tax consequences*.

Financial markets trustees were able to breathe a sigh of relief, at least insofar as the requirement to provide information to central registers was restricted to those trusts which generated a tax consequence. In common with many other financial instruments in which trusts are commonly used, the trusts arising in most securitisations, for example, would not be said to "generate a tax consequence" for these purposes and therefore would not require reporting to a central register.

Although AMLD4 was finalised in June 2015, a draft version of the UK's implementing regulation (the snappily titled *Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations* ("**MLR**" for brevity)) was only released in March 2017 and the regulations themselves were only laid before parliament one working day prior to commencement. As such, there was very little time to prepare for the new regulations. There was no equivalent consultation process as there had been for AMLD4 and there is little guidance which exists as at the date of this article as to the application of MLR in the context of the trustees' duties.

MLR imposes an obligation on trustees of "relevant trusts" to maintain accurate and up to date written records relating to the trust's beneficial owners and potential beneficiaries and to provide certain information about those beneficial owners and potential beneficiaries to relevant persons and law enforcement authorities on request.

In respect of trusts which generate a tax consequence, information must also be provided to Her Majesty's Revenue and Customs ("**HMRC**") on an annual basis for inclusion on a register which will be available to HMRC and law enforcement agencies in the UK and European Economic Area ("**EEA**") states.

While the obligations which MLR imposes on trustees are broadly consistent with the spirit of Article 31 (in particular MLR imposes no obligation to provide information to a central registry unless the relevant trust generates a tax consequence), the requirement to maintain written records of beneficial ownership places a considerable burden on professional trustees who often administer thousands of financial trusts. In addition, it is unclear whether the obligation extends to maintaining records of all individual beneficiaries whose identity a trustee would be capable of ascertaining or whether, as one reading of MLR might permit, a trustee need only record as a "class" those beneficiaries of a trust where not all of the individual beneficiaries are capable of being identified (for example all "secured creditors" in the context of a securitisation).

As the trustee community seeks to obtain clarity on the existing provisions of MLR, the European Commission continues its crusade to weed out those pernicious devices which lurk behind the benign façade of equity's darling. In early December 2017 the compromise text (resulting from negotiations among the European Parliament, the Council and the Commission) for a further revised (5th) AMLD ("**AMLD5**") was published. Among the changes proposed in the compromise text is a requirement that all express trusts, irrespective of whether or not those trusts may be said to generate a tax consequence, must be disclosed to a central register. On its face the change may have appeared to European law-makers to be small, but its implications are potentially vast. In addition to the many thousands of financial market instrument trusts which may require central registration, every bank or investment firm holding segregated client money or client assets does so (as a matter of English law) on trust and would have to register each and every one of those trusts and their beneficiaries, in many cases representing their entire client base. In many cases, trusts are used simply as a drafting technique to address particular commercial issues, for example so called "turnover trusts" requiring parties to finance agreements to account to one another for proceeds which they receive outside the terms of their agreement. Each such trust and its beneficiaries would require registration. And this is to say nothing of the consequences of failing to register trusts that arise day-to-day in the personal lives of individuals living in common law jurisdictions, covering everything from family insurance arrangements to residential real estate transactions.

Businesses will doubtless be concerned about access to data on their business affairs, such as access to their client lists which have commercial value. We anticipate further concerns about the security of the systems and the ability of the registrar to verify that access is only granted to those who actually need it and not others who falsely claim to require information for AML purposes.

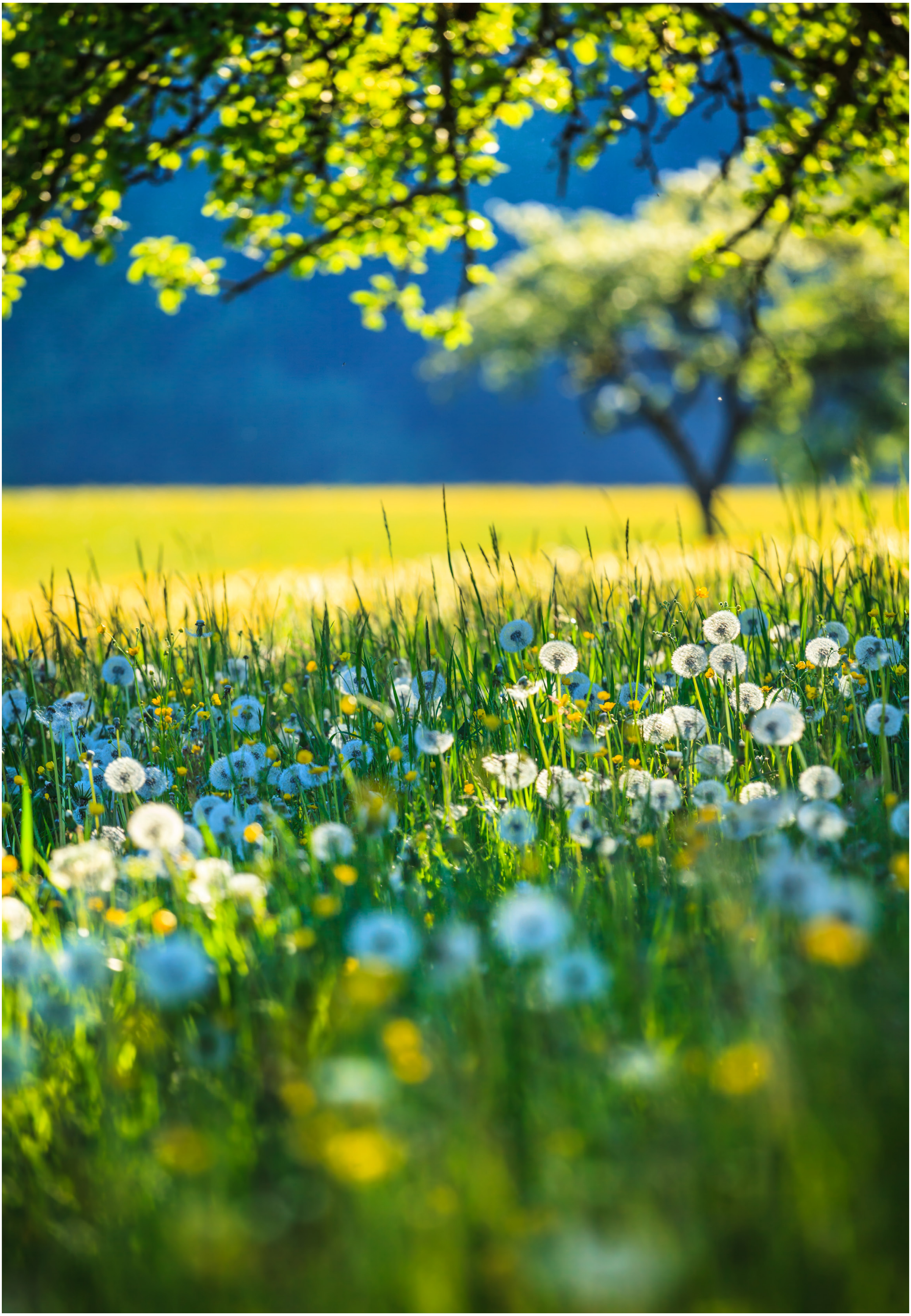
The requirement to maintain up to date registrations of beneficiaries is likely to be extremely burdensome (especially, although not exclusively, in the case of the publicly traded instruments), in particular where the class of beneficiaries fluctuates over time and if registrations cannot simply describe the class of beneficiaries as a class. Consider also the burden (in terms of time and cost) of tracking down each and every reference to trusts in existing commercial documentation (even where this is in fact possible). Given the changes do not appear to contemplate any sort of grandfathering relief, all this would need to be done on a retrospective basis and then regularly updated.

The compromise text envisages that Member States shall:

- bring into force the necessary implementing laws and regulations by 18 months following entry into force; and
- set up the central beneficial ownership registers by 18 months after entry into force (for companies) and 20 months after entry into force (for trusts).

At the time of writing this article, the directive has been approved by the European Parliament and the Council but has not yet been published in the Official Journal. It is expected that it should be published around the middle of 2018, which would suggest that the revised central trust registers should be up and running by the end of 2019 or in early 2020. Given the transitional period before the UK leaves the EU, it is possible (indeed likely) the UK will seek to implement the requirements either because the terms of the UK's transitional agreement dictate it must do so or because the UK will feel constrained to follow the EU approach to demonstrate the equivalence of its AML standards.

Absent a successful further lobbying of the UK and Irish governments, we anticipate a great many participants in the financial markets (including professional trustees) will be impacted. A far wider understanding of the implications of AMLD5 and the disruption it could cause is required, including within the investor and lender community who rely on trust arrangements being an integral part of funding structures on securitisation and lending transactions. Additionally, the practical aspects of implementation of the new requirements are also likely to create issues as firms may well need to build new IT systems to manage the registration requirements and an 18 month period is unlikely to be long enough to prepare for the impact.



RISK RETENTION US AND EU DUAL COMPLIANCE: CASE STUDIES

Following the financial crisis, the European Union ("**EU**") and the United States ("**US**") enacted broad range of regulatory reforms that have had a significant impact on securitisation transactions. Included as part of these reforms are rules that aim to discourage the "originate to distribute" model of credit underwriting by requiring securitisation sponsors (in the broad, colloquial sense of the term – meaning the entities organising and directing the transaction) to maintain some "skin in the game". More particularly, sponsors are required to retain a specified portion of the credit risk associated with the assets they are securitising. While the goals and certain features of the risk retention regimes implemented by the US and EU are similar, the detailed rules differ in certain important respects. Now that both the EU and US regimes have been in place for a while, this article takes the opportunity to compare and contrast the approaches, as well as opportunities and challenges of designing dual-compliant structures.

In the EU, the existing triad of risk retention rules applicable, respectively, to credit institutions, AIFMs and insurers have been around for the best part of a decade and are generally well understood, although difficult cases still remain. As outlined earlier in this publication (see our article entitled "The EU Securitisation Regulation: arrival at base camp"), the Securitisation Regulation will overhaul the EU rules with effect from 1 January 2019. Among other things, the existing EU rules will be recast under a single regulation governing the activity of securitisation, rather than scattered through prudential regulation affecting particular types of institutional investors. While the detail of the EU risk retention rules under the new regime (including new regulatory technical standards) have yet to be finalised, it is not expected that the broad themes discussed in this article related to the challenges of complying with both the US and EU risk retention regimes will change materially under the new European rules.

The US rules, on the other hand, have only been in place for between 18 months and two and a half years, depending on the asset class. Market practice for dealing with the US risk retention rules in Europe is, accordingly, still developing. Since Rule 144A private placements of European (and especially UK) securitisation bonds into the US have been on the rise in the last year, this seems an appropriate moment to review the practical issues for sponsors seeking to comply with both the EU and US risk retention rules. The following discussion highlights some important considerations under both regimes, particularly in the context of a cross-border securitisation transaction that must comply with both the EU rules and the US rules.[1]

The EU rules and forms of retention

Under the EU rules, one of the originator[2], sponsor[3] or original lender must maintain a "material net economic interest" in the securitisation of at least 5%. The options available to the retainer in order to fulfil this risk retention obligation are limited. Broadly, it must choose from one (and no more than one) of the following options:

- a vertical slice of the liabilities of the securitisation;
- the originator's interest (or seller share) in a revolving securitisation;
- a random selection of assets from the pool it is intended to securitise;
- a first loss tranche of the liabilities of the securitisation; or
- a first loss interest in each of the securitised assets.

The US rules and forms of retention

Section 15G of the Securities Exchange Act of 1934, as amended, and the accompanying regulations implemented by US regulators (collectively what we refer to as the "**US risk retention rules**" or simply the "**US rules**") require the "sponsor"[4] of a "securitization

[1] Because of the relatively insignificant nexus with each jurisdiction required to trigger their respective risk retention rules, this is not uncommon. A typical scenario would be (1) EU rules triggered by the wish to market to EU-regulated investors or (from 1 January 2019) a securitisation sponsor who is established in the EU, such as an EU bank; and (2) the US rules triggered because the book built for the initial offering of the securitisation contains at least 10% of by fair market value of the bonds sold to US persons (as defined for the purposes of the US risk retention rules), meaning that the sponsor may not avail itself of the foreign transaction exemption, or any other exceptions admissible under the rules.

[2] An originator is, broadly, either an entity involved in the original creation of the assets or an entity that has bought assets for its own account and then securitised them.

[3] In addition to the more colloquial sense in which the word is used elsewhere, "sponsor" has a regulatory definition in each of the US and the EU risk retention rules. It is defined in the EU rules broadly as an entity that establishes and manages a securitisation that purchases third party assets. Only entities with particular kinds of regulatory status are eligible to be sponsors under the EU rules.

transaction"[5] to retain a 5% economic interest in the credit risk of the transaction. Sponsors must choose one of a number of standardised risk retention options, consisting of:

- an "eligible vertical interest" ("**EVI**");
- an "eligible horizontal residual interest" ("**EHRI**");
- a combination of both vertical and horizontal ("**L-Shaped**");
- in the case of a revolving master trust, a "seller's interest"; and
- various alternative retention options tailored to specific asset classes.

On the surface, a number of the EU and US options would appear to be very similar. Indeed, the seller share/seller's interest, the vertical slice/EVI and the first loss/EHRI options would all appear to be highly compatible. In the following sections we examine this more closely by comparing and contrasting the application of the detailed EU and US risk retention rules to three typical risk European transaction structures that might be sold into the US under Rule 144A. We also analyse some edge cases and potential difficulties down the line.

Credit card master trust: seller share retention

The EU rules applicable to revolving securitisations provide for retention of an originator's interest of no less than 5% of nominal value of the securitised exposures. In practice, EU master trust/revolving pool securitisations often comply with the risk retention obligation in this way regardless of whether the transaction is intended to be dual compliant.

The US rules also permit the sponsor of a revolving pool securitisation to retain a seller's interest consisting of at least 5% of the unpaid principal balance of all outstanding securities issued to investors. A revolving pool structure is defined as one in which the issuing entity is established to issue multiple series and classes collateralised by a common pool of securitised assets that will change in composition over time, and that does not monetise excess interest and fees from its assets. A typical master trust structure meets these requirements. The seller's interest is generally an ABS interest that is collateralised by the sponsor's assets, must adjust for fluctuations in the outstanding principal balance of the pool and be, prior to an amortisation event, subordinate to or *pari passu* with any series of ABS interests sold to investors. Notably, the seller's interest excludes certain assets allocated only to a specific series or class along with certain other items (such as cash reserves) specified in the US rules. As a result, while the quantum of the required retention may differ given that the EU rules require 5% of the nominal value of the securitised exposures and the US rules require 5% of the unpaid principal balance of all outstanding investor ABS interests, the retention method of the sponsor holding an undivided trust interest in the receivables trust alongside the securitisation investor beneficiary is permitted under both sets of rules.

In practice, EU originators/sponsors have found that holding the retention piece in a single entity in a manner designed to comply with both the EU and US rules is both possible and easily achievable. Indeed, of all the structures we have analysed, the master trust structures have had the fewest difficult edge cases to work through. In the UK at least, the way in which large retail bank master trust structures tend to be managed has meant that seller shares are typically much larger than would be needed to meet the risk retention requirements of either jurisdiction. As a consequence, the economic factors in retention strategies are less relevant for such structures.

Standalone RMBS: vertical retention

Both the EU and US rules allow a sponsor to retain credit risk in the form of a vertical interest, and since the introduction of the US rules, many sponsors have chosen to use vertical retention, particularly in cross-border securities offerings that must comply with both EU and US rules.

Under the US rules, a sponsor who chooses to retain risk in the form of an EVI must retain a 5% position of each class of ABS interests issued as part of a single securitisation transaction.[6] The definition of "ABS interests" under the US rules is broad and notably includes any securities, obligations, beneficial interests, and residual interests issued by the issuer – whether such interests are certificated or not – so long as the holder of such interest would receive payments that depend primarily on the cash flows from the underlying assets.

By contrast, the EU rules require the retention of "not less than 5% of the nominal value of each of the tranches sold or transferred to investors". While these seem superficially similar, the definition of the term "tranche" in fact limits the retention obligation to those interests that represent assumption of credit risk (i.e. the risk that principal may not be repaid). Because instruments such as residual certificates represent a right to income, and not repayment of principal, they are able to be excluded from a retention structure that complies only with EU rules.

[4] "Sponsor" is defined in the US rules as the "person who organizes and initiates a securitization transaction" by selling or transferring assets either directly or indirectly, including through an affiliate, to an issuer of a "securitization transaction".

[5] "Securitization transaction" is defined in the US rules as a "transaction involving the offer and sale of asset-backed securities by an issuing entity".

[6] Alternatively, the sponsor may retain a single vertical security that entitles it to a specified percentage of not less than 5% representing same portion of each class of securities.

The inclusion of residual and uncertificated interests in the US definition can therefore result in a sponsor retaining more risk under the US rules than under the EU rules for the same transaction. For example, in a standard securitisation capital structure where several classes of notes and a residual/excess spread certificate are issued by the issuer, a sponsor choosing to retain risk in the form of an EVI under the US rules will need to hold 5% of the principal balance of each class of notes and 5% of the residual certificates issued at closing, as each are considered ABS interests. In this scenario under the EU rules, the sponsor would only need to hold 5% of the notes and not the certificated excess spread or other similar interest. This difference between the EU and US rules is most relevant for private transactions where securitisations are created to be placed with certain investors who have restrictions around the manner in which they hold exposures to assets. For example, if an investment bank arranges a securitisation specifically for a bond investor who is looking to take a "0-100" exposure to a pool of assets (with the investment bank holding the risk retention piece), in order to comply with the US rules, that investment bank would need to hold 5% at all levels of the transaction, including the excess spread. Under the EU rules, 100% of the excess spread could be sold to the investor. While this is clearly workable in most cases, it does of course have economic/pricing implications for the transaction.

Standalone RMBS: first loss/horizontal retention

Both the EU and US rules allow the sponsor to retain risk in the form of a horizontal interest, representing the "first loss" position with respect to the entire asset pool, to ensure that the sponsor bears the risk of loss before investors. Once again these rules seem superficially similar but – of our three examples – the horizonal interests are the least similar when the EU and US rules are compared in detail. In many cases sponsors have found such dual compliance challenging to achieve, especially in the portfolio acquisition financing space.

Under the US rules, a sponsor choosing to hold an EHRI must retain at least 5% of the fair value of all ABS interests issued as part of the securitisation transaction, as determined using a fair value measurement framework under US generally accepted accounting principles. The EHRI must be a first loss piece, and may consist of one or more of the most junior ABS interests in the issuing entity. The US rules require additional disclosure to describe the assumptions, methodologies and estimates utilised in arriving at the fair value determination – a requirement that does not exist for the EVI option or under the EU rules and one which can require significant additional cost where such methodologies are externally verified. The disclosure must be provided a reasonable period of time prior to the sale of securities (in practice this typically means it is contained in the preliminary or "red" prospectus) and must include, if final information is unavailable, a range of fair value estimates. Details regarding the actual amount of retained interest must also be provided a reasonable period of time after closing. That disclosure is typically included in the reports delivered to investors in connection with the first payment date.

In practice, the time and cost associated with preparing the more extensive disclosure, including the engagement of third party valuation experts to provide and/or verify the assumptions and conclusions that feed into the fair value determination and disclosure, have discouraged many (but not all) sponsors from choosing to hold retention in the form of an EHRI.

Determining the size of the first loss piece is much simpler under EU rules, but can sometimes lead to perverse results. In the EU, the first loss tranche is sized at 5% of the *nominal* value of the underlying securitised exposures (i.e. the assets) but regulatory guidance has added that this must "represent downside risk". These are important differences compared to the US rules which are based on the *fair* value of the securities (i.e. the liabilities). The result is that the sizes of the required retention pieces may be radically different under the two sets of rules, and dual compliance will force sponsors to hold the horizontal interest to the larger of the two values – which will normally be the amount calculated under the EU rules if the portfolio is acquired by the sponsor at a discount.

To put this into context, if a portfolio is acquired at a significant discount (say, purchasing at 50% of par value) a short time before a securitisation take-out where the assets are sold in at par (as is often the case with legacy mortgage portfolios), retaining a 5% nominal first loss tranche of the liabilities of the securitisation would not generally be accepted as representing exposure to downside risk, since recovery of more than 50% of par value on the portfolio would still represent a profit to the sponsor. The EU rules therefore require that the sponsor retain the "46-50" part of the capital stack in those circumstances. This, of course, means a greater proportion of the real credit risk must be retained than would be the case on a portfolio not acquired at a discount. In our example, 5 must be retained out of a portfolio acquired at 50, representing 10% of sponsor's real credit risk on the underlying portfolio. The bigger the acquisition discount, the more extreme this effect will be.

By contrast, under the US rules, the requirement is simply to hold a 5% first loss position in the ABS interests (or liabilities) by fair value. This may result in the sponsor retaining slightly more than a nominal 5% of the bottom of the capital stack, but not typically as much as would be required under the EU rules. As a result, relatively few portfolios purchased at a discount have horizontal retention on the related securitisation take-out.

Other key differences between the EU and US rules

Who has the obligation?

Under the US rules the obligation of the sponsor to hold retention is direct, and there are no obligations placed on investors or other participants to verify or monitor that the sponsor is in compliance. The EU rules have historically been the opposite. They have required investors to verify that the securitisation was compliant with the relevant rules before investing. However, from 1 January 2019, the Securitisation Regulation will impose a direct risk retention obligation on the sell side that will largely align with the US rules in putting the retention obligation on the sponsor. EU institutional investors, however, will still be responsible for verifying these obligations are complied with before investing.

Retention options

The EU and US rules each permit a sponsor to hold risk retention in formats that are not available under the other rules. For example, the US rules permit eligible horizontal cash reserve accounts and L-Shaped retention, among others, which are not available under the EU rules. Conversely, the EU rules permit retention of randomly selected exposures outside of the securitisation and the retention of a first loss piece in each securitised exposure which are not available under the US rules. While not a complete bar on the sponsor's ability to use these options in a cross-border dual compliance scenario, the challenges and inefficiencies in doing so make these options less practical in most scenarios.

Lifetime of the retention obligation

Under the EU rules retention is required for the life of the transaction, while the US rules are usually less onerous. Under the US rules, the retention requirement depends on the structure and asset class:

- for revolving pool securitisations relying on retention of a seller's interest, retention is required for the life of the transaction;
- for RMBS transactions, the retention must be held until 5 years after closing or until the principal balance of securitised assets is reduced to 25% of closing date balance, whichever is later; and
- for other asset-backed securities transactions, the retention must be held until 2 years after closing or until the principal balance of the securitised assets is reduced to 33% of closing date principal balance, whichever is later.

Applicability of the rules for certain transactions.

Although both the EU and the US rules are meant in general to cover securitisations, the substantive scope of the rules is in some respects quite different.

The EU rules, for example, only apply to tranched arrangements, with the result that a number of transactions that might be considered "securitization transactions" for US purposes (and therefore subject to US risk retention rules) would escape the application of EU rules entirely. Repackaging transactions, which are effectively single-tranche securitisations, are a good example.

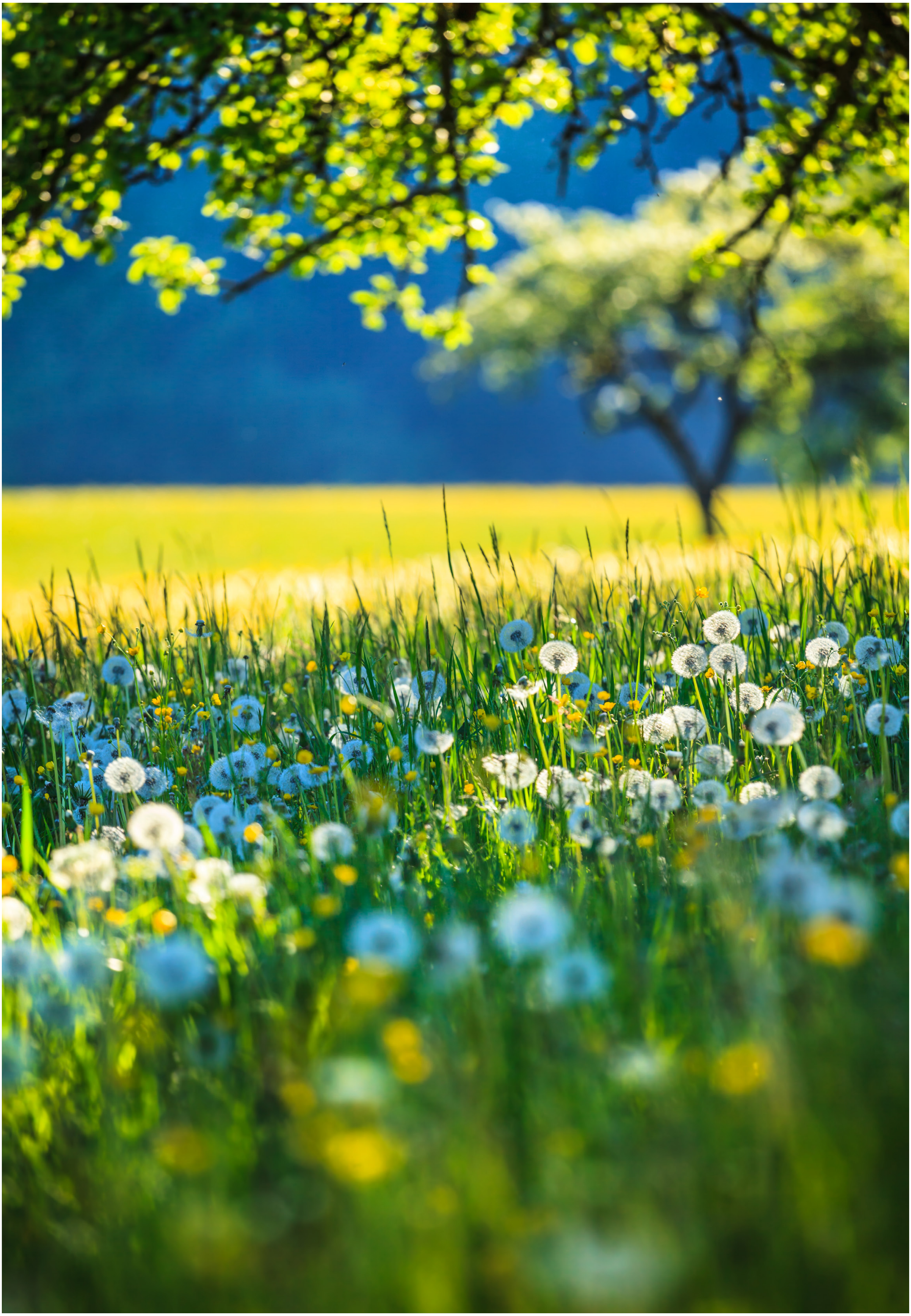
Conversely, a number of transactions are caught by the EU definition of a "securitisation" (and therefore subject to EU risk retention rules) but are not likely to involve "asset-backed securities" for US purposes, and therefore would not be subject to the US rules. These include:

- synthetic securitisations;
- transactions involving collateral that is not self-liquidating (i.e. aircraft); and
- tranched, limited recourse asset-backed lending arrangements in the form of loans (e.g. receivables financing arrangements) rather than securities.

In addition, recently, US federal courts held that the US rules are not applicable to any new or existing open market CLO managers (i.e. hired third party CLO managers who merely direct the acquisition of assets but have never themselves owned the assets transferred to the issuer) emphasizing that a sponsor must actually be a transferor who relinquishes "ownership or control of the assets to the issuer". While we expect market participants to apply these principles and seek favourable rulings for other transactions, we note that the court's decision does not in any way impact the applicability or impact the EU rules or the requirement of CLO managers or transactions to comply with them, as previously required.

Conclusion

While there are clearly challenges that the market is facing in how to comply with both regimes in a way that best serves the competing requirements, by and large EU-based sponsors have been able to access the US markets and comply with US risk retention requirements without making major changes to their securitisation structures. Dual compliance has been particularly straightforward for large UK master trust structures which have been able to adapt with comparable ease. Significant structuring concerns remain, on the other hand, with portfolio acquisition RMBS transactions.



REGULATORY ROUNDUP

I. THE PROSPECTUS REGULATION

From July 2019, the Prospectus Regulation (EU) 2017/1129 ("**PD3**") will repeal and replace the Prospectus Directive ("**PD**") regime in full. This update highlights the timing and key features of PD3, discusses the additional underlying requirements (which are still in progress) and comments on the broader regulatory landscape.

PD3 – Timing and key features

The majority of the provisions will not apply for another year (21 July 2019) but PD3, as a regulation with direct effect in Member States, is already on the books and a couple of provisions are already in effect. Of these, the most relevant for structured debt transactions is the new ability to admit a limited amount of additional fungible securities (up to 20% per annum of the amount of existing securities) to trading on the same regulated market without having to produce a further PD-compliant prospectus. This is only an exemption from the requirement to produce a prospectus for admission to trading (and not relating to a public offer of securities) however, as securitisations and covered bonds are typically only offered in denominations of EUR 100,000 or more, a separate public offer exemption would normally apply as well.

These are a few highlights of the provisions likely to be relevant for securitisation and covered bond prospectuses from July 2019:

- **Scope:** Like the current PD regime, PD3 will be relevant for offers to the public in the EEA and admission to trading on EEA regulated markets. There is no extension to "multilateral trading facility" or "MTF" platforms or the even less regulated "organised trading facilities" or "OTFs".
- **Denominations and disclosure:** Helpfully (and after extensive lobbying), PD3 retains a lighter disclosure regime for debt with denominations of EUR 100,000 or above ("wholesale" debt) – including an exemption from the requirement to produce a prospectus summary. Although less relevant to structured debt (in view of Securitisation Regulation disclosure obligations), PD3 also introduces lighter disclosure for securities only sold to "professional" investors and admitted to trading on a "professionals only" market or segment of a market. As yet, few markets would fit this description, but some may develop. The nature and detail of the disclosure is to be outlined in level 2 measures.
- **Prospectus summaries:** In rare cases where securitisation transactions are done with lower denomination securities, summaries will be required and will be limited to 7 pages. They will need to be in a format prescribed by level 2 measures with only individual tranche summaries required on programmes. Where relevant, PRIIPS "key information documents" or "KIDs" may be used in lieu of the summary, but the difficulty of producing KIDs for structured transactions is such that this route is unlikely to be adopted by any significant portion of the market.
- **Communications, offers and exemptions:** These concepts remain largely unchanged from the current regime. As mentioned above, the EUR 100,000 denomination public offer exemption will remain, as will the "qualified investors" and the "fewer than 150 person per EEA state" exemption. A point of continuing debate is the fact that a simple "communication" will henceforth be classed as an advertisement. Despite lobbying, ESMA did not feel empowered to adjust this at level 2.
- **Risk factors:** This is likely to be a point of debate on deals as a result of a new requirement that the most material risks should be mentioned first. This will require an element of "crystal-ball gazing" and will require a period of market adjustment before new market practice can be settled.
- **URD and secondary issuance:** For completeness, although it seems unlikely to be used in structured debt markets, PD3 introduces the concept of a shelf-type "universal registration document" (URD), a live document which will be reviewed and approved, but may assist with shorter approval times. There is also a slightly lighter disclosure regime for certain secondary issuance.

Level 2 measures – Timing and status

As with the current PD regime, the PD3 regime comprises of various layers. PD3 sits at "level 1" in the Lamfalussy structure of EU legislation – that is, high level "skeleton" concepts to be embellished by further detailed "level 2" regulations. The European Commission mandated ESMA to prepare recommendations and will prepare delegated acts on the basis of ESMA's technical advice.

To date, ESMA has issued two sets of consultations in July 2017 and December 2017 (on topics including the scrutiny and approval of prospectuses, content requirements for different types of products, prospectus summary content and content for EU growth prospectuses). It produced the first of its final reports at the end of March 2018, with draft technical standards for consideration. The European Commission will use the proposals to prepare draft delegated acts by June 2018, to be translated and adopted by October 2018 – in theory, providing ample time for digestion by the market. These would then apply from 21 July 2019, after the usual objection period by the European Parliament and Council.

ESMA's March 2018 Final Report included, amongst other things, the proposals for prospectus content. ESMA has commented that the Final Report "takes as a starting point the existing prospectus regime, largely proposing to maintain what has proved to be a set of requirements that works well" and including "changes aimed at easing requirements for issuers, with a view to reducing the cost and administrative burden in using a prospectus, as well as a number of additional disclosure requirements that are deemed necessary for investor protection."

The March 2018 Final Report includes 27 separate Annexes, with suggested product disclosure. One small practical improvement for programmes is that ESMA has included the categorisation of each disclosure item (such as Cat A, B or C – indicating whether information must be included in a Base Prospectus or may be added in Final Terms) in a separate column in the relevant securities note schedule, rather than as a separate Annex.

As regards asset-backed securities, ESMA proposed certain changes to the current required content such as to risk factors and to website information and documents on display. It is also worth noting that whilst ESMA has included some provisions to reflect the new Securitisation Regulation (EU) 2017/2402, it has retained the current definition and scope of application for the disclosure annexes relating to "asset backed securities", a term defined very differently to the way "securitisation" is defined under the Securitisation Regulation. Notably, the definition of "asset backed securities" references only an interest in assets or securities secured by assets (not dissimilar to the "securitisation" concept of "a pool of underlying exposures") but makes no reference to tranching or the effect of tranching. Accordingly, it is much broader and includes e.g. repackaging transactions well as securitisations.

PD3 in the context of a "Rubik's cube" regulatory regime

As ever, context is everything. The philosophy of retaining lighter disclosure for high denominations at level 1 is very helpful, as is ESMA's suggestion that, where possible, its level 2 PD3 content proposals build on existing disclosure. The practical usefulness of this might, however, be limited by the onerous disclosure requirements imposed under the Securitisation Regulation. In addition, there will inevitably be an adjustment period to the new regime in July 2019.

Moreover, in addition to any new specific PD3 measures, there will be other factors to take into account:

- First, on 20 September last year, the Commission put forward a completely separate proposal for a Regulation (commonly referred to as "Omnibus 3") which includes a requirement that all asset backed securities and securitisation prospectuses produced by EU issuers and all third county issuer prospectuses for any type of product should be approved centrally by ESMA, rather than by individual competent authorities. There has been lobbying against this, but the outcome is not yet clear. As drafted, the proposed regulation would only apply to prospectus approvals after a transitional period of 36 months.
- Secondly, it is worth emphasising that, for practitioners operating in the securitisation world after July 2019, PD3 measures are being created not only in the context of the Capital Markets Union (CMU) project – which includes, for example, the new Securitisation Regulation – but, also, in an environment of increasing regulatory intervention and a myriad of EU and US measures. In addition to the increased transparency requirements imposed under the Securitisation Regulation, regulators are increasingly requiring further transparency and further safeguards arising for other reasons. These range from controls on interest rate benchmarks and "robust" fallbacks (imposed under the Benchmarks Regulation) through to influencing the potential investor base to whom certain products may be sold (arising out of MiFID2). It is no exaggeration to say that virtually all recent regulations impact securitisation and structured debt products in some way, and each of them plays a role in deciding where to list, what to say in any prospectus, which legending to include and the appropriate investor base.

II. PRIIPS

The Packaged Retail and Insurance-Based Investment Products ("**PRIIPs**") Regulation is intended as an investor protection measure to ensure retail investors in the European Economic Area ("**EEA**") are provided with appropriate information before they invest in complex products. Under its rules, a "manufacturer" or "distributor" making a PRIIP available to a retail investor on or after 1 January 2018 is required to provide that retail investor with a key information document ("**KID**"), which is a three page summary of the product in highly regulated format. The brevity and heavily prescribed nature of the KID makes it very difficult or impossible to prepare one for even the simplest of securitisations. KIDs not only need to be provided at the time the product is initially offered, they also need to be kept up to date throughout the life of the product, making the regime even more onerous. Fortunately, after some initial consternation and market uncertainty, the structured debt markets have largely settled on sensible documentary solutions to ensure compliance with the PRIIPs Regulation

There was some initial uncertainty – some of which remains – around the scope of products to which the PRIIPs Regulation applied, as well as around the meaning of the phrase "to make available" to retail investors. Since then, market practice has evolved either to address the relevant regulatory issues (to the extent they apply) or to avoid them arising.

While the scope of products treated as PRIIPs has been the subject of much debate in vanilla debt markets, the structured debt markets have largely been able to ignore this issue, thanks to their wholesale nature. It is clear that most securitisations will be PRIIPs, since the definition includes "instruments issued by special purpose vehicles …or securitisation special purpose entities… where…the amount repayable to the retail investor is subject to fluctuations because of exposure to...the performance of one or more assets which are not directly purchased by the retail investor". It is less clear that covered bonds will always be PRIIPs (since they are fundamentally secured bank bonds – so the credit should normally depend on the issuing banks, rather than the assets). However, as securitisations and covered bonds are both mainly sold only to professional investors anyway, the markets have chosen to formally exclude retail investors from transactions and thereby avoid the problem entirely.

The importance of not making a PRIIP available to retail clients

Given that the structured debt markets have chosen to go the route of excluding retail investors from investing in order to deal with the PRIIPs issue, it is important to understand who is a retail investor for these purposes and what is meant by the term "making available", as the penalties for non-compliance are harsh.

The concept of a "retail investor" in the PRIIPs Regulation is closely aligned to the definition of "retail client " in MiFID2, meaning EEA firms will by now (given the 3 January 2018 application date of MiFID2) already have effective systems in place to identify such investors. It is helpful that most active investors in securitisation and covered bond markets are professional clients, rather than retail clients, for MiFID2 purposes. The definition of professional investor does not, however, include entities such as some local authorities and small companies which might occasionally have invested in structured debt markets in the past, so particular care will need to be taken to ensure that such entities are subject to appropriate "know your customer" checks to ensure they can be treated as professionals before they are allowed to continue investing. Market participants should also take care when using certain terms such as "wholesale", "professional" and "qualified" investors; these are often used interchangeably but the concepts derive from different sources and are not identical, despite some overlap. For example, the expression of "wholesale investor" is not a technical term at all, although it generally is used to refer to investors who participate in offerings with "wholesale" denominations of EUR 100,000 or more. "Qualified investor", on the other hand, is a term defined under the Prospectus Directive in a way that is largely – but not perfectly – aligned with the concept of professional clients under MiFID2.

As to the concept of "making available, it has always been clear that it is broader than the concept of "offering", so it would not be sufficient, for example, to include a selling restriction in the initial offering of a structured product. Beyond that, however, there has been significant speculation, with serious consideration being given to the possible need for transfer restrictions on structured products. It was also thought that it might be necessary to restrict listings of structured products to "professionals-only" markets, as the mere fact of admitting a product to trading on a regulated market might be sufficient to make it available to retail clients permitted to trade on such markets. Fortunately, this has since been clarified by the Joint Committee of European Supervisory Authorities, who have confirmed that a KID is not required for a product merely because it is listed on a regulated market as long as it is clear that the product is not meant for retail investors.

Accordingly, the solution adopted by the structured debt markets is to pair a "no sales to retail" selling restriction with a legend that makes clear that no KID will be prepared because the product may not be on-sold to retail investors. These restrictions are also included in screen announcements. Template wording for the legends and selling restriction have been published by the International Capital Markets Association and are now widely used in the market.

Does the PRIIPs Regulation apply to covered bonds?

It is clear that securitisation products are more or less all PRIIPs. As mentioned above, this is less clear in respect of covered bonds. On a strict reading of the legislation, a straightforward covered bond with a hard bullet may well fall out of the scope of the PRIIPs Regulation because the expectation is that repayments to investors will depend on the credit of the issuing bank, rather than on the performance of the cover pool. However, market participants have been cautious about taking this approach, not least because certain features seen relatively frequently in the markets such as “soft-bullets”, which make it harder to exclude covered bonds with certainty from the scope of the PRIIPs regime. There is also some debate whether a distinction should be made based on whether the product is a structured covered bond or one that relies on statutory ring-fencing of the cover pool.

As covered bonds have historically been primarily offered to professional investors in any case, the market has taken a cautious view and tends now to document covered bonds in the same way as securitisation products for the purposes of complying with the PRIIPs Regulation. Legends and selling restrictions are therefore typically included in deal documents since that obviates the need to come to a firm conclusion as to the PRIIP status of the particular product without significantly affecting marketing.

III. MIFID2

After a lengthy implementation period, MiFID2 finally came into force on 3 January 2018. It has given rise to significant changes in many aspects of financial services, such as sales and trading and the provision of investment research, and securitisation is no exception. This impact (and the impact on the capital markets generally) was in most cases identified relatively late in the implementation process, but market practice is quickly settling. The main areas of interest to securitisation are product governance, inducements and allocations.

Product governance

The main MiFID2 topic of importance to securitisation is the new product governance regime. Prior to MiFID2, there was no harmonised EU regime applicable to firms which create and/or distribute financial instruments. Mis-selling scandals and a political desire to ensure that financial instruments are fit for purpose led EU legislators to impose a common set of rules on firms, relating to the way in which they design, distribute and monitor financial instruments. The new rules are broad: they apply in respect of all financial instruments (including securitisation bonds) whenever an EU investment firm (which includes EU banks) is involved in "manufacturing" or distribution, regardless of investor location. Since "manufacturing…encompasses the creation, development, issuance and/or design of financial instruments", the product governance rules have significant extra-territorial effect.

In short, the rules require manufacturers of a financial instrument to comply with certain standards when designing the instrument (e.g. they must match the features of the instrument to the identified needs of a defined "target market" for the instrument). The rules also require the manufacturer (or co-manufacturers, as is often the case) to ensure that the instruments are distributed in line with the manufacturer's design parameters. This means that the manufacturer will want a contractual relationship with distributors, under which information is exchanged about distribution, and problems identified by the distributor. For example, in order to comply with its obligations to monitor the instrument, the manufacturer will oblige the distributor to send it details of any complaints received from investors.

Where there are multiple manufacturers, they are required to "outline their mutual responsibilities in a written agreement." ICMA has produced draft "co-manufacturer" language which could be used for this purpose in a subscription agreement or an agreement among managers. Where an entity that would otherwise be a co-manufacturer is not a MiFID investment firm, the requirement for a written agreement will still apply to any co-manufacturer that is a MiFID investment firm.

The distributor has its own obligations under the product governance rules where it is an EU investment firm, even where the manufacturer is not subject to the rules (i.e. where the manufacturer is not established in the EU).

In the context of a typical securitisation transaction, an EU financial institution sponsoring or arranging the transaction will almost certainly be a MiFID entity, meeting the criteria to be an "investment firm". The securitisation issuer is far less likely to meet such criteria, as it does not provide investment services to third parties or activities on a professional basis.

In general, all the joint lead managers and co-managers will either be manufacturers, distributors or both for the purposes of the rules. What category they fall into depends on the actual work they do on the transaction and whether it is simply a distribution role (as would generally be the case for co-managers) or they actually get involved in the structuring or product design.

All of the above has a distinctly "retail" feel about it, but the product governance rules formally apply in respect of both retail and professional clients. In terms of practical impact, however, the securitisation market has begun to settle on less onerous ways to comply. In particular, MiFID2 makes it clear that, for manufacturers, their compliance with the product governance requirements should be done in a way that is appropriate and proportionate, taking into account the nature of the financial instrument, the investment service and the target market for the product. Given that holders of securitisation bonds are almost always professional investors (not retail), market practice is to conclude that compliance with the product governance rules can take advantage of the above proportionality concept and thereby avoid being too onerous for the institutions involved. This means that a firm can take into account the professional nature of the investor base when complying with each requirement. For this reason – among others – it is increasingly common for primary issuance of many types of capital market instruments to be expressly confined to professional investors.

Controls on the receipt and payment of inducements

MiFID2 strengthens existing rules on the receipt and payment of inducements (e.g. fees or commission received by a firm from someone other than its client, in relation to a service provided by the firm to that client). The debate over the disclosure of underwriter's commission to investors has revived, in circumstances where the same firm is acting for the issuer and also placing the issuance with its own clients. ICMA has seen a lively debate on this question, with firms now starting to settle on resolving the issue by ensuring that the investors are not treated as their clients.

Allocation rules

MiFID2 imposes new requirements on investment firms when they are involved in allocation of financial instruments in respect of a primary issuance. The firm will be required to have a specific allocation policy and will be required to discuss and agree certain issues (e.g. agreement on the proposed method of allocating instruments) in advance with the issuer or – in the case of most securitisations – the originator.

In part, these new rules are designed to address potential conflicts that arise where an investment firm owes obligations to the issuer but can also benefit from allocating instruments to particular investors (e.g. in order to win business from that investor). This means that allocation policies (and how they are implemented in practice) will be subject to greater scrutiny by firms and their regulators, to ensure that allocation is conducted fairly. These rules apply in respect of distribution of securitisation bonds to investors.

Conclusion

The key legal questions in respect of product governance are now well known in the industry, i.e. which entities are manufacturers; what terms should they put in place between manufacturers and with distributors; and what can be disapplied on the basis of a proportionate implementation of the rules. Market practice on these and the other MiFID2 issues is settling.

IV. THE PROPOSED NPL DIRECTIVE

Non-performing loans[1] ("**NPLs**") have received increased attention from the EU as reducing current stocks of NPL portfolios and preventing their future accumulation on banks' balance sheets is viewed as a critical factor in completing the EU's Banking Union and developing the Capital Markets Union.

On 14 March 2018 the European Commission released an ambitious package of binding and non-binding measures to further promote the reduction of NPLs. The proposal targets NPLs in four different ways:

A. amending the Capital Requirements Regulation for banks by (i) providing for minimum coverage levels for new loans that become non-performing and (ii) introducing a definition of non-performing exposures;

B. introducing a new out-of-court collateral enforcement mechanism for certain secured business loans intended to increased efficiency and value recovery when enforcing security;

C. reducing barriers to entry into the secondary market for NPLs by introducing (i) a passporting system for credit servicers (ii) obligations on selling credit institutions to make certain disclosures to credit purchasers and (iii) obligations on credit purchasers to make certain disclosures to competent authorities; and

D. a blueprint for the establishment of national asset management companies.

The passporting system for credit servicers and new disclosure obligations have the most significance for the securitisation market, so we will examine these proposals in more detail. They are proposed as part of a directive on credit servicers, credit purchaser and recovery of collateral (the "**NPL Directive**").

What does the NPL Directive seek to achieve?

The NPL Directive sets out a framework for the purchasing and servicing of loans originated by EU banks (regardless of whether they are performing or non-performing). It also introduces a new accelerated extrajudicial collateral enforcement ("**AECE**") mechanism available to certain categories of secured creditors.

The NPL directive aims to facilitate pan-European private risk sharing while alleviating the need for future public risk sharing. NPLs are viewed as hindrances to a bank's performance for two main reasons. First, they have an impact on the profitability of banks, and where there is a significant build up of NPLs this could have implications for the stability of the affected banks and the financial system as a whole. Second, NPLs limit a bank's capacity to provide new loans to the market as banks' regulatory capital is tied up because it has to be held against their outstanding loans.

Once implemented, the hope is that the NPL Directive will promote transparency during NPL sales and more cost-effective servicing and enforcement of such loans. It is further hoped that this will encourage smaller investors to enter the NPL markets and increase competition by reducing barriers to entry. The market value of NPLs is expected to increase accordingly and banks would therefore be further incentivised to prevent the accumulation of NPLs.

Authorisation and passporting for credit servicers

The NPL Directive introduces a new requirement for credit servicers to be authorised before commencing servicing activities. "Credit servicers" has broadly been defined to include any person (other than banks) that carries out activities including the monitoring of performance of loans, collecting and managing information regarding the status of credit agreements, informing the borrower or changes in rates and charges and exercising rights and performing obligations on behalf of the creditor under the credit agreement. In order to become authorised, a credit servicer would need to provide evidence to the relevant competent authority that it is established in the European Union and it has appropriate policies and standards in place to manage the treatment of borrowers. The NPL Directive also permits outsourcing by credit servicers to third parties subject to certain conditions.

Although this new regime places new initial administrative burdens on credit servicers, it is intended to expand the credit servicing market in the EU. Following the completion of certain notification procedures between the competent authorities in the home and host Member States, any authorised credit servicer would have the right to provide the services covered by that authorisation throughout the European Union.

The scope of the definition of credit servicer appears to be too broad in some areas – cutting across established regimes in the securitisation and loan markets, while failing to capture nuances of NPL portfolios, in particular:

A. **Non-bank agents and security agents:** the NPL Directive does not distinguish between credit servicers of an individual loan vs. a portfolio of loans and whether the loans themselves are performing or non-performing. It therefore appears that non-bank facility agents and security agents for loan market transactions would be required to be authorised

[1] NPLs have been defined as loans where the payments are more than 90 days past due or where the loan is assessed as unlikely to be repaid by the borrower.

credit servicers before they are permitted to act on behalf of a syndicate of banks or secured creditors in relation to a loan. See our briefing entitled "*EU legislative measures for non-performing loans – impact on the loan markets: new regulation of loan transfers, non-bank lenders and facility agents*"[2] for more detail.

B. **Potential delays in the perfection process:** securitisation transactions regularly contain powers of attorney ("**PoA**") in favour of the security agents from the seller or originator of the loans granting rights to the security agent including, but not limited to, the right to enforce and set interest rates on the loans. Such PoAs are given as security for the performance of the seller's or originator's obligations and often become exercisable upon the occurrence of certain events which trigger the transfer of legal title in the loans to the securitisation special purpose vehicle. The wide definition of "credit servicer" under the NPL Directive would appear to capture non-bank security agents in such circumstances. It is not clear from the NPL Directive whether the SPV would be required to become authorised following the granting of the PoA or when the relevant security agent decides to exercise the PoA. In either case, this could cause delays and additional costs for transactions using non-bank security agents.

C. **Real estate ownership ("REO"):** REOs are a resolution strategy available to credit purchasers of NPL portfolios where the loan is enforced and possession of the underlying property is taken by the credit purchaser from the borrower. Separate SPVs are normally incorporated by purchasers for the purpose of owning the property and property managers are appointed by the property-owning SPVs to service the cash flows and manage property generally. Depending on the business plan and strategy of the purchaser, it is possible that a significant proportion of an NPL portfolio could be held in the form of REO properties instead of loans. The NPL Directive makes no reference to REOs or property managers and therefore a single NPL portfolio could be subject to divergent levels of scrutiny by EU and national regulators depending on the proportion of REO properties in the portfolio. Although it is noted that following an REO resolution the NPL is normally extinguished, clarification should be sought in relation to this to ensure the consistent treatment of credit purchasers and credit servicers that the NPL Directive seeks to achieve.

Rights to information and obligations on credit purchasers

A public consultation conducted by the European Commission found data quality and availability of information as a main obstacle to the development of the secondary market for NPLs. The consultation cited bank secrecy, consumer privacy and the lack of standardisation of data as key factors which have contributed to information asymmetry in the secondary NPL market, thus impeding its development. The NPL Directive seeks to address these findings by introducing a more uniform set of disclosure requirements and standards for banks and credit purchasers, thereby reducing barriers to entry and increasing competition between potential investors, which is intended to ultimately increase the price of NPLs for banks. In summary, the obligations are as follows:

A. an obligation on banks to (i) provide non-bank purchasers with information that would allow them to assess the value of the credit agreement and likelihood of recovery; (ii) notify the competent authority of the details of any transfers of credit agreements to non-bank purchasers; and (iii) ensure that such information provided to non-bank purchasers conforms to the standardised formats as will be set out in the implementing technical standards published by the EBA, a draft of which is proposed to be submitted to the European Commission by 31 December 2018; and

B. an obligation on non-bank purchasers to inform the competent authority of (i) its (or its representatives') intention to directly enforce a credit agreement; (ii) any changes to the credit servicer; (iii) details of any transfer of a credit agreement from the non-bank purchaser to another non-bank purchaser.

NPL portfolio acquisitions are already subject to extensive and lengthy due diligence processes, so a standardised format applicable across the EU as described in A above may indeed be helpful in expediting this process and reducing costs over time.

That said, and although the proposals may promote more NPL disposals in some Member States, they may also have a number of unintended consequences. In particular, given the NPL Directive does not distinguish in this respect between performing loans and NPLs, the proposals could inadvertently hinder the primary syndication market of performing loans as they introduce new administrative and compliance burdens and disclosure obligations on parties where non-bank syndicated lenders are involved. See our briefing entitled "*EU legislative measures for non-performing loans – impact on the loan markets: new regulation of loan transfers, non-bank lenders and facility agents*" for more detail.

[2] https://www.cliffordchance.com/briefings/2018/04/eu_legislative_measuresfornon-performingloan.html.

V. THIRD PARTY EFFECTS OF ASSIGNMENT OF CLAIMS

In March 2018, the European Commission published a proposal for a conflicts of laws rule on the third party effects of the assignment of claims. The new proposal is part of the European Commission's Capital Markets Union project and does not contain substantive rules of law. Rather, it would determine what national law would apply to determine the proprietary effects of assignment of claims in cross-border transactions. This is by contrast to the existing Rome I Regulation that determines the national contractual law applicable in such cases. The proposed new regulation would help parties determine, for example, what national legal system's procedures need to be followed in order to ensure the effective perfection of legal title over an assigned claim (such as a receivable). It would also determine what national law would apply to resolve conflicts regarding the assigned claim (e.g. which assignment is effective in a case where the same claim is purported to be assigned twice to different assignees by the same assignor).

The general rule proposed is that the law of the country where the assignor has its habitual residence at the material time would determine the validity of the assignment. However, where such assignment is made in view of a securitisation, the parties may choose to have the governing law of the assigned claims govern the proprietary effects of the assignment as well. This election must be made expressly, either in the assignment agreement or a separate agreement.

For example, where a German company is assigning English law-governed receivables to a Luxembourg company, the general rule would be that German law would govern the third party effects of the assignment of claims (so, for example, German law procedures would need to be followed to perfect the assignment and ensure its effectiveness against third parties). English law would continue to govern the receivables and (under the Rome I Regulation) the parties could elect the governing law of their choice to govern the assignment agreement.

However, if the assignment is in view of a securitisation the German and Luxembourg companies could jointly elect to have English law govern not only the underlying claims/receivables being assigned, but also the assignment agreement (which they have long been able to elect under the Rome I regulation) and the proprietary effects of the assignment of the claims (under the proposed new regulation). This would mean that the parties to the transaction (including, importantly, the investors in the securitisation) could have confidence that the claims had been effectively assigned where English law perfection procedures had been followed.

The availability of the securitisation-specific election rule is very helpful, and aligns with the market practice of perfecting assignments of claims according to the rules of the law governing that claim. The availability of this election is also particularly helpful where there are multiple originators in different jurisdictions or the originator is acting via multiple branches. In such cases, application of the general rule would likely prove costly for a securitisation SPV that may have to comply with multiple sets of local laws to ensure effective assignment of claims, even where all of the underlying assets were governed by the same law. This also simplifies and increases certainty around assignments of claims for securitisations because it allows the parties to ensure all aspects of the transaction are governed under the same law.

Scope of proposed Regulation

As mentioned above, the new proposal would only apply to the proprietary aspects of assignment of claims, such as determining applicable registration requirements in order to fully transfer legal title to a claim. The Rome I Regulation will continue to apply to contractual aspects of the relevant assigned claim.

Impact on securitisation

It is very helpful that – although the proposed new regulation wasn't put forward specifically to address securitisation issues – it nonetheless takes account of the specific needs of the securitisation market. Ensuring that claims have been effectively transferred from the originator to the securitisation SPV is a fundamental element of securitisation, as it ensures the insolvency remote nature of the securitisation structure. A high degree of certainty is required as to the applicable law for the assignment of the underlying assets of the securitisation, in order to ensure that the claims have been effectively transferred out of the insolvency estate of the originator and are considered to be part of the securitisation. Designing the rules in such a way as to facilitate the alignment of the laws applicable to the underlying assets, to the contractual elements of the assignment of claim and to the proprietary elements of the assignment of claim is also very helpful.

Areas of uncertainty

Pursuant to Article 4(1) of the proposed regulation, the general rule applicable to all assignment of claims is the law of the country in which the assignor has its "habitual residence at the material time".

That said, the concept of the "material time" is unclear. For example, it is difficult to determine whether this should be the date that the assignment is initially agreed or the date that the assignment is perfected (such as date of registration of the assignment). In the case of English law securitisations, the date of assignment of the beneficial title and the date of perfection (if any) may be years apart, giving rise to significant scope for a change of habitual residence of the assignor in that time.

Even where it is possible to work out what the "material time" is in respect of a given transaction, parties may need to determine the assignor's "habitual residence" at a later stage (e.g. where a conflict arises and litigation is in prospect) when evidence to determine the location of its habitual residence at the material time is harder to come by.

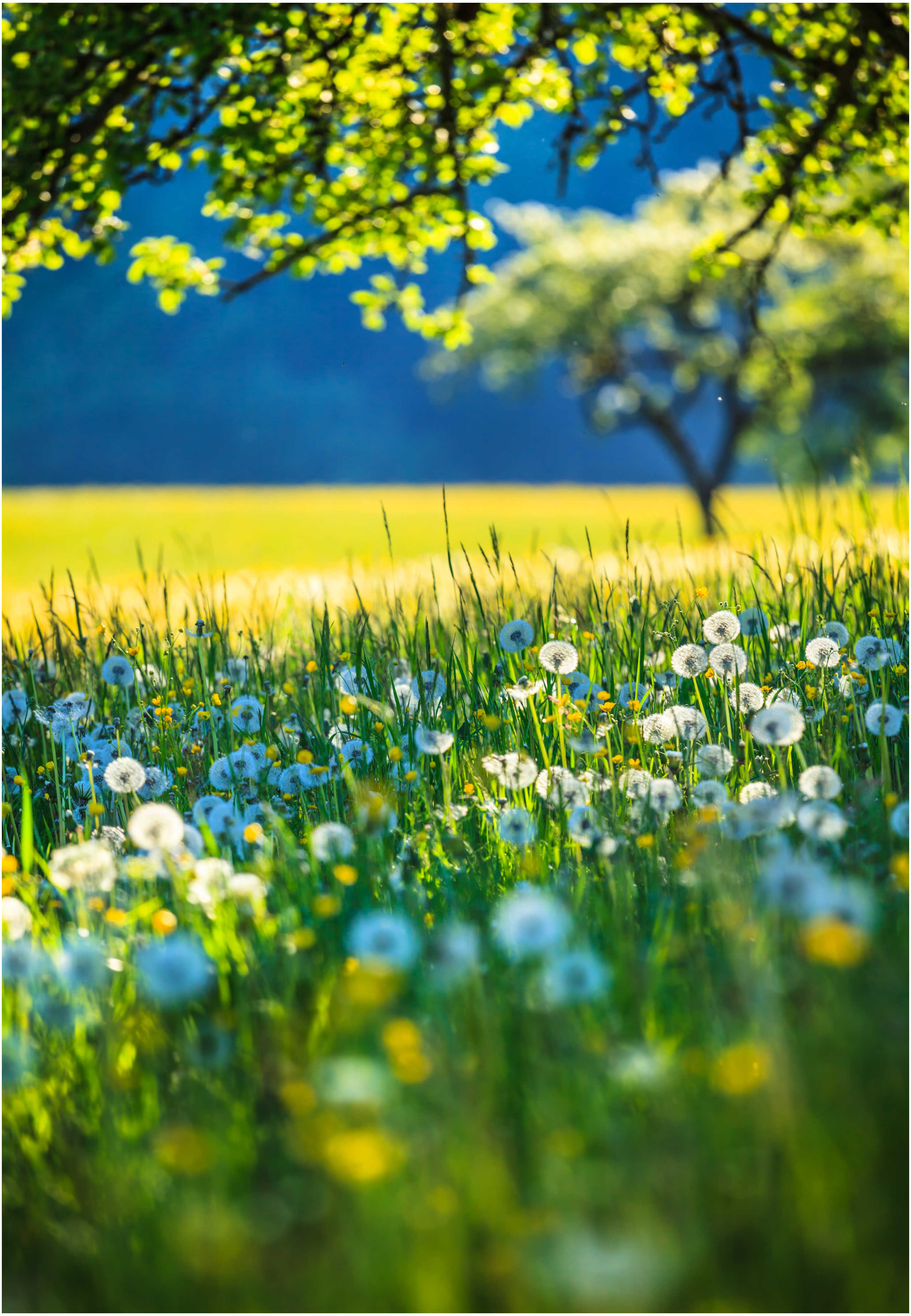
Finally, the term "habitual residence" does not account for assignment of claims by a branch of a company. This would benefit from clarification along the lines of the Rome I Regulation.

Given the uncertainties surrounding the habitual residence concept, it is in general helpful that securitisation benefits from a specific exception. The securitisation exception, however, is subject to uncertainties of its own. Chief among these uncertainties is that the term "securitisation" is undefined in the proposed Regulation. While it is likely that a "securitisation" for these purposes would be defined by reference to the Securitisation Regulation (which definition is very similar to the existing CRR definition), this will require an amendment to the proposed regulation in order to provide the required certainty.

Application and timing of Regulation

The timing of the proposed regulation is uncertain. However, the proposal suggests that the new regime should apply from 18 months following the date the regulation enters into force and in relation to assignments made after a certain date (yet to be determined), suggesting that assignments made prior to such date will be grandfathered.

For parties doing business in the UK or under English law, it is relevant to note, however, that the UK will be required to opt into the new regulation for it to apply. At the time of publication, it was not yet clear whether the UK would choose to do so.



CMBS: RECENT DEVELOPMENTS AND FUTURE CHALLENGES

The CMBS markets are, perhaps more tentatively than the rest of the securitisation markets, beginning to show signs of a resurgence. In this article, we examine the challenges to the revival of the CMBS markets and suggest what might be done to offer a more hospitable environment for CMBS exits to real estate finance lending going forward.

Introduction

If the last two or three years have taught European CMBS market participants anything, it is to treat any predictions of the rebirth of their market with a great deal of caution. Despite the occasional, whispered predictions from industry panels – made more in hope than expectation – and despite the best efforts of the CMBS 2.0 initiative, the European CMBS market has recently consisted of a handful of issuances from a small crowd of the usual, noble suspects.

However, there have been signs over the last year that the whispers could turn into more confident voices. There has been evidence that, this time around, there could be a real resurgence of the European CMBS market. BAML's Taurus 2017-2 UK logistics deal in November 2017 priced at levels that caused even previously inactive market participants to sit up and take notice. The Pietra Nera Uno Italian agency CMBS transaction in February 2018 saw Blackstone enter the market. In addition Blackstone closed FROSN DAC, a Finnish office and retail CMBS, in April 2018. A number of other CMBS transactions are also in the pipeline.

The signs are positive on two fronts. First, signs are that banks habitually wedded to syndication as the only realistic exit strategy from their commercial real estate assets are beginning once again to find CMBS an attractive alternative. To this we can add a hope that the re-birth of the market in Europe will lead to other sponsors/borrowers will becoming more familiar and comfortable with the documentary and other requirements that are necessary to enable CMBS exits. Second, the recent Pietra Nera transaction may encourage other borrowers to consider CMBS funding through agency structures as a viable alternative to direct bank financing.

That said, the market has so far turned a corner largely for single loan deals, with the vast majority involving the same sponsor who is familiar with the requirements that CMBS imposes on the loan level negotiations; the underlying loans have in general been negotiated with the CMBS exit in sight, and with the sponsor's buy-in.

It goes without saying that making CMBS a viable exit option for lenders generally requires ensuring that certain features are incorporated into the loan documentation in order to better adapt them to the needs of a CMBS transaction. To this end, it would be helpful to make borrowers and sponsors more familiar with these features throughout the commercial real estate markets. If this is successful, it may open the market even more, potentially to include some of the multi-loan deals that were done in the pre-crisis years but have thus far been absent post-crisis.

To help promote familiarity with CMBS, we run through below some of the loan-level features it requires in a bit more detail. Considering how they have been dealt with on recent transactions will give us a clue as to how easy it might be for some of them to be incorporated more widely in the commercial real estate loan market. As we shall see, while a lot of the features work well at the moment, others have thrown up a few more issues with the exercise of making loans CMBS-ready.

Making the loan CMBS viable

To make a loan viable for a CMBS exit, the following areas in particular should be considered during the course of the loan negotiation:

- Assignability of the loan, including whether or not either the consent of, or consultation with, the borrower is required for an assignment to an SPV issuer.
- Making the rating triggers in the loan agreement (for the account bank and hedge counterparty), together with the related downgrade and replacement requirements, compliant with the current criteria of the agencies that are rating, or that are likely to rate, the resulting CMBS.
- Permitting disclosure of the loan agreement and details of the borrowers and properties to investors in the marketing materials and ensuring that the information covenants in the loan documentation allow CMBS issuers to satisfy ongoing regulatory reporting requirements under the securitisation. In this regard, it is important to bear in mind the new, expanded disclosure requirements in the Securitisation Regulation.

- Eliminating, as far as possible, the risk of any basis rate mismatch between the underlying loan and the notes by ensuring that interest accrual periods and determination dates match as far as possible (which may mean that loan interest periods do not start and end on loan interest payment dates).
- Ensuring that the representations and warranties relating to the loan in the facility agreement are sufficiently robust to enable the lender in turn to give an appropriate set of representations and warranties in the loan sale agreement and, among other things, make any "no material change" and litigation statements required in the offering document regarding the borrowers.
- Ensuring, as far as possible, that the borrower indemnities in the facility agreement cover any special servicing and other fees that the issuer might be required to pay in a default or other work out/restructuring scenario.
- Allowing reliance on the various due diligence reports and valuations to be extended to the issuer and the trustee for any CMBS (and enabling the valuations to be incorporated by reference to the offering document, which is likely to require the consent of the valuer).

Many of these are not problematic and have been shown to work well already on the basis of the current market standard loan provisions. For example, the LMA-standard confidentiality provisions are accepted by borrowers in the vast majority of commercial real estate loans in the market and permit the necessary disclosures for CMBS marketing materials. The assignment mechanisms will also normally permit assignment to a securitisation issuer without requiring the consent of, or consultation with, the borrower.

However, a few of the other elements in the list above have raised more questions on recent transactions, and it is worth exploring some of these in a bit more detail.

Rating agency requirements

Ensuring that borrower account banks and hedging agreements are with suitably rated counterparties – and incorporating rating-standard downgrade and replacement provisions – has proved difficult in some cases, not least because of the relative scarcity of appropriately rated counterparties. This is even true in circumstances where a CMBS exit is specifically contemplated and the loan is being negotiated with a cooperative sponsor. The difficulties even arise in agency CMBS transactions where the borrower is necessarily invested in the CMBS process. Commercially and logistically, it has proven to be difficult to ensure that borrowers have suitably rated counterparties on board in the first place, and to contractually require them to replace such within 30 days of downgrade as required by current rating agency criteria.

Given the difficulties that arise even where favourable conditions exist at the time of the loan origination, it is likely to be an even harder sell for loans that are being negotiated where a CMBS exit is a mere possibility to be kept open and/or where the sponsor is (at best) agnostic as to the exit strategy. This will therefore remain a challenge, although increasing familiarity with the issue, and possible pricing advantages obtained by keeping CMBS exit strategies on the table, may help to resolve these over time.

Furthermore, where (as in the most recent CMBS deals) the rating agency process for the CMBS to some extent runs in parallel with the loan negotiation, it will generally be possible to enquire with the relevant agencies as to the rating impact on the CMBS capital structure of any non-compliance at loan level. Perhaps, as has been the case a couple of times recently, the rating agencies may get comfortable that there will be no adverse impact (for example, regarding borrower level account banks, the rating agencies may take the view that there is limited downside risk given the frequency of the cash sweep) although this will obviously turn on the particular facts of the transaction involved.

Of course, this kind of dynamic structuring based on rating agency feedback will not be an option where the lender is merely seeking to keep the CMBS option on the table for later consideration, rather than running the process is in parallel with the loan negotiations. In such cases, the loan documentation should seek to provide as much flexibility as possible: for example, the rating requirements, downgrade and replacement provisions should ideally be matched to the latest rating criteria of each of S&P, Fitch, Moody's and DBRS. But even this may not be enough: rating agencies can and do change their criteria with little or no notice, and borrowers are unlikely to agree to any requirement beyond complying with the criteria that are in existence at the time the loan closes.

While loan-level hedging is likely to be in the fairly simple form of an interest rate cap, the same commercial and logistical challenges exist in terms of requiring borrowers to source appropriately-rated counterparties in the market who are willing to enter into hedging documentation on terms that comply with the downgrade and replacement (or, in certain cases, collateral posting as an alternative) requirements set out in the latest rating criteria. For CMBS transactions that are negotiated in parallel with the loan, getting a hedging provider in position for CMBS close can sometimes be a problem. The result is that borrower-level hedging has sometimes not been entered into at the time the CMBS goes to market (albeit that investors have the assurance of the contractual requirements of the required hedging conditions under the loan).

Disclosure and reporting requirements

Another area where the CMBS potentially impacts the loan-level negotiation is the relevant applicable disclosure requirements, and in particular the listing requirement for enhanced disclosure on "significant" borrowers and the new expanded disclosure requirements being introduced under the Securitisation Regulation. These "significant borrower" disclosure requirements bite when there are a limited number of loan level borrowers in in the CMBS in total, or where there is a borrower or borrowers who account for a significant proportion of the total underlying collateral. Disclosure rules will generally require "significant change" and "no material adverse change" statements from these borrowers, as well as requiring these borrowers to file financial statements.

For the issuer to be able to comply with these obligations and give the appropriate statements in the offering document (for which it will have to take responsibility) lenders will need to ensure the appropriate representations and covenants are in place under the loan agreement. This is yet another area that is less of a problem when the CMBS process runs in parallel with the loan negotiation and the borrower is onside with the process. With loans that are merely being set up to be CMBS-viable at some point in the future, it may be more of a challenge to persuade the borrowers to give the relevant representations in a form that the issuer will be able to replicate in the offering document to comply with the listing requirement.

Report providers and reliance

Borrowers' cooperation is also needed to ensure that reliance on the various loan-level due diligence reports can be granted to the SPV issuer and the trustee for the CMBS. Again, this may less of a problem when the CMBS is in train during the loan negotiation process (or is expected to occur shortly afterwards) as often report providers are prepared to extend reliance to any entity that becomes a new finance party within six months of loan closing. But it becomes more difficult where a CMBS is proposed further down the line: it will be much harder to engage borrowers and for them to engage report providers to extend reliance to an SPV (and trustee) at a later date. The issues are even more challenging in respect of report providers as the reports may well be out of date by the time the CMBS is done and so providers may have legitimate reasons for not permitting further reliance on their work absent a (potentially costly) update.

Risk retention

The recent Blackstone Pietra Nera Uno transaction brought back into focus the awkward application of European risk retention rules in respect of agency CMBS transactions. Each transaction will need to be examined on a case by case basis, but there are some cases where it is arguable that pure agency CMBS transactions (i.e. where the secured financing to the borrower is provided directly by the special purpose vehicle through the capital markets) should not be subject to the risk retention requirements because the transactions are more akin to a secured financing provided to the borrowers than they are to a more traditional securitisation. Certainly the "originate to distribute" problem that risk retention rules exist to address does not arise in respect of agency CMBS transactions.

Each transaction will be looked at on its own facts, but in some cases it will be possible to conclude that the risk retention rules do not in fact apply. Even in such cases, investors may require the retention of 5% as a commercial matter or because of local legislation/ interpretations. In this case, one would then need to examine who the most appropriate entity would be to retain the 5%. For agency transactions this may well be the borrower itself.

The applicability of US risk retention rules is another point that needs considering. The involvement of various US parties, including a significant element of US participation in the investor book, will be sufficient to bring the transaction into scope, so careful consideration needs to be given to the identity of investors and the approach to the US risk retention rules that the parties wish to take. In some cases, it may be relatively straightforward to comply, but otherwise care will need to be taken to ensure that an exemption to the rules is available so as to avoid accidentally falling foul of these rules.

Dual compliance with the EU and US risk retention rules is complicated in the case of CMBS because one of the more common methods of risk retention for European CMBS under the EU regulations – retention of 5% of the whole loan – will not satisfy the requirements of the US regulations. As a result, other methods of retention that satisfy both the EU and the US requirements need to be explored. One such method is the granting of a loan by the originator/ sponsor to the issuer to finance 5% of the acquisition of the loan, which loan has a *pari passu* entitlement to 5% of all interest and principal receipts under the underlying loan, with a 5% pari *passu share* in all principal losses.

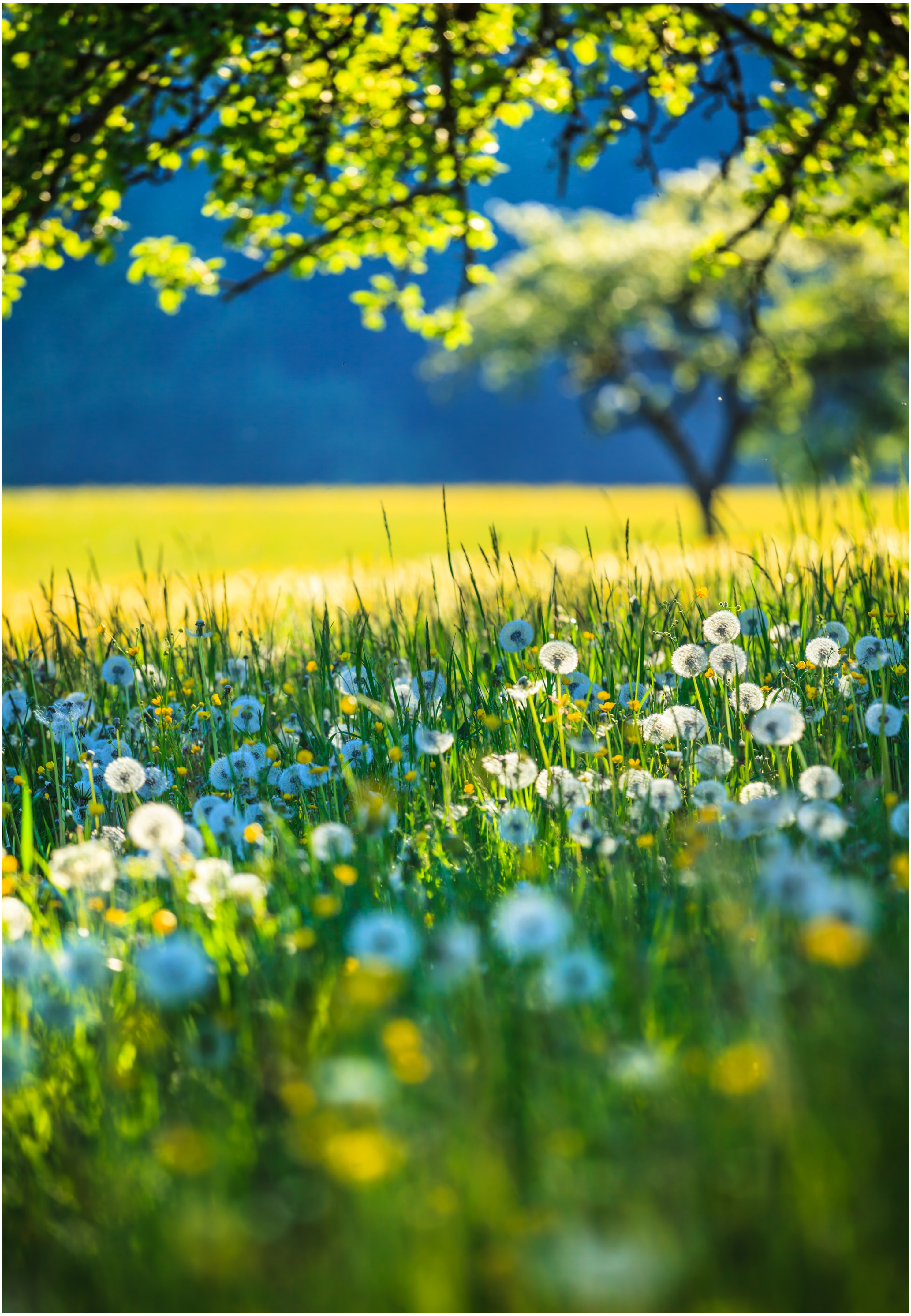
CMBS, Solvency II and the Securitisation Regulation

Another challenge to revival of the CMBS market is the capital treatment that CMBS bonds receive under EU prudential regulations, and in particular under Solvency II. Under Solvency II, CMBS are classed as type 2 securitisations, meaning that they attract a significantly higher regulatory capital charges as compared to type 1 securitisations (a category limited to certain RMBS, auto securitisations and business loan securitisations). Many market participants feel this capital charge to be unjustified given recent performance of CMBS issuance (especially in the light of improvements made to CMBS structures post CMBS 2.0). Perhaps worse, the capital charges associated with a senior tranche of CMBS debt is often higher than the capital charge associated with investing in the whole loan without any of the credit enhancement associated with a senior CMBS exposure. Certainly, the capital charges under Solvency II act as an effective deterrent from insurance companies investing in the single-A or BBB part of the capital structure.

Furthermore, it is possible that the disparity between the capital treatment afforded to CMBS and other asset classes may well be increased as a result of the Securitisation Regulation: while the expectation is that the STS standard will allow for beneficial revision of the Solvency II capital charges, this is will only be the case for securitisations that meet all of the STS criteria. CMBS will not benefit from this as it will not qualify as STS. There are currently no indications that CMBS is likely to benefit from any revisions to Solvency II capital charges in the foreseeable future.

Conclusion

While it is too early to herald the new dawn of the CMBS market, the signs are nevertheless beginning to point in the right direction. Real progress will be made when a wider array of sponsors/borrowers become familiar with – and sympathetic to – the CMBS pressure points discussed in this article, and are accordingly more willing to incorporate the necessary features into the loan documentation. In time, this ought to enable lenders to achieve CMBS exits for their commercial real estate loans without having the borrowers as involved and invested in the process to the degree they are currently are. This, in turn, may pave the way to more ambitious, multi-loan structures.



PORTFOLIO ACQUISITIONS AND FINANCING: RECENT DEVELOPMENTS

The story of the portfolio disposals and financing market in recent years has been one of continued growth, as more and more portfolios come to market across an increasing number of jurisdictions. In this article we will look at recent trends in the market, covering both performing and non-performing portfolios and across both the residential and commercial real estate sectors.

2017 was no exception to the recent trend for growth in the market for portfolios, with over €104 billion (face value) of transactions closed across various jurisdictions in Europe, as reported in Evercore's European Distressed Real Estate market report of January 2018. These high volumes are unsurprising given the continued significant political pressure for banks to increase the pace at which they reduce their exposures to non-performing loans. High transaction volumes are also encouraged on the demand side with high levels of competition among sponsors chasing value in the portfolios that come to market.

So far, 2018 appears to be continuing the trends seen in 2017. The markets most active last year, such as Spain and Italy, have continued to see a number of transactions (either closed or still live), with more portfolios expected to come to market over the coming months. In addition, there is a renewed focus on markets that have yet to see significant portfolio disposals, such as Greece and Portugal. Outside of Europe, a significant increase in the acquisition of Chinese and Thai loan portfolios by western investors is anticipated. Accordingly, we expect sponsors and the banks active in financing portfolio acquisitions to continue to increase their focus on these markets.

Proposed regulatory reform

Before discussing portfolio disposals market trends, it is worth highlighting some recent regulatory proposals published by the European Union in what has hitherto been a market fairly insulated from direct regulation, especially as compared to the post-crisis securitisation markets in general. As noted above, the political pressure on European banking institutions both to clean up their balance sheets by reducing exposures to non-performing loans and to avoid any future significant build-up of NPLs has only been increasing. While the European Commission has recently acknowledged progress in reducing stocks of NPLs on bank balance sheets, it simultaneously highlighted that the European NPL disposal market has thus far been concentrated in the UK, Ireland, Spain and Italy.

The NPL progress report published by the Commission in March was accompanied by a draft legislative package consisting of a draft directive and a draft regulation, the stated intention of which is to encourage the development of secondary markets for non-performing loans (defined by the EU as a loan which is more than 90 days overdue or assessed to be unlikely to be repaid by the underlying borrower) across the European Union. The details of the proposals are beyond the scope of this article, but see our separate summary in the "Regulatory Roundup" section of this publication. That said, there are a number of key proposals worth mentioning here as, if they are adopted as proposed, it is clear that they will have an impact on current market practices.

The first such key proposal is contained in the proposed directive and seeks to create a new requirement on the sellers of NPLs to disclose all necessary information to enable the purchaser to assess the value of the loan exposure and the likelihood of recovery. While it is too soon to assess what impact this will have, this is a notable shift in emphasis from the current market approach which, as we will discuss below, is very much based on the "buyer beware" principle. At present sellers offer limited or no representations in respect of the loan assets, thereby forcing sponsors and their lenders to rely almost exclusively on their own extensive due diligence on the portfolio. This is because there is typically little or no recourse other than to the loans and related security acquired in the transaction.

The second key proposal is for the introduction of a regime under which credit servicers would be required to be authorised and regulated by Member States. For non-bank sponsors whose business model is to acquire portfolios and then engage a servicer or asset manager to perform the day-to-day management of the portfolio, this will restrict the range of servicers they can employ and add cost to the servicing function. While this may not be a major issue for larger sponsors, many of whom have already acquired servicing and origination platforms in the more active non-performing loan jurisdictions, this is clearly a proposal that will have an impact on market practice for portfolio disposals and create or increase barriers to entry for new servicers and prospective sponsors. This will be especially true in jurisdictions with hitherto low levels of NPL portfolio acquisitions where servicing practices may not be as well-developed.

A buyer beware market

Although there is certainly no template sale and purchase agreement ("**SPA**") employed across the portfolio disposals market, there is a common general approach that applies both to the market for residential portfolios (performing and non-performing) and non-performing commercial real estate portfolios. Under that common approach, the sellers offer as little comfort as possible in the form of representations and warranties on the portfolios. On commercial real estate NPL portfolios, the representations and warranties will typically cover only the fundamental corporate and solvency issues, as well as unencumbered title to the assets being sold. On performing residential mortgage portfolios, the same coverage would be offered, plus basic asset-level representations around key aspects of the nature of the portfolio and servicing. Where representations and warranties are given at all, they are virtually always accompanied by a fairly short sunset period, a cap on liability and a *de minimis* threshold that applies before any claim can be brought.

In the commercial real estate NPL market, this has led to sponsors undertaking especially detailed due diligence when underwriting the portfolio, the results of which their funders also need to be comfortable with since the lending is limited recourse to the portfolio itself. A similar approach is taken in respect of residential mortgage loan portfolios, although here some consideration must be given to exit strategy – the exit may well be a public securitisation where the sponsor will need to prepare a comprehensive disclosure package, often with little or no assistance from the seller. Absent representations and warranties available from the seller, this is yet another reason the due diligence undertaken will be especially important.

Considerations for lenders on commercial real estate NPL portfolio acquisitions

We now turn to recent trends in the market for financing commercial real estate NPL portfolios, although we would highlight that this is a market where there is no one-size-fits-all approach. This has been particularly evident recently where the number of portfolios containing both deeply non-performing commercial real estate loans as well as more granular residential mortgage loans has been on the increase.

Although the lending market for NPL portfolio acquisition remains fairly bespoke on a transaction by transaction basis, the themes discussed above in relation to representations and warranties in SPAs of course have knock-on effects on the financing packages offered to sponsors to fund their acquisitions. In the early years following the financial crisis when the flow of loan portfolios coming to market was more of a trickle than the current waterfall, finding leverage on sponsor-friendly terms was a much more difficult task and the covenant packages on offer to sponsors were very tight. This has changed over time as the number of players has increased, both in terms of equity chasing the best portfolios and senior lenders chasing financing opportunities in a similar and parallel race. This growth in the number of players has coincided with a general market experience of portfolios performing ahead of business plan expectations, resulting in the acquisition debt being repaid ahead of schedule and the sponsors making healthy returns. As one would expect in any competitive market where demand exceeds supply, there has accordingly been a trend towards relaxation of the debt terms available to sponsors.

A key consideration from a lending perspective when putting together a financing package is the lenders' exit strategy. The commercial real estate NPL markets have been characterised in general by syndication exit strategies, which fit better with the nature of the portfolios and the reliance on the sponsor to execute its business plan. This is in contrast to the residential mortgage loan portfolio market which, as we discuss below, tends to be ultimately financed through public securitisation to achieve the best debt pricing possible.

While there are certainly common themes to the financings of NPL portfolio acquisitions, another important factor is that individual sponsors long active in the market now have fairly well-developed precedent financing documentation with their lenders. Accordingly, much of the negotiation between lenders and sponsors tends to be focussed on striking the right balance between protecting the senior debt and allowing the sponsor sufficient flexibility to manage the portfolio, execute its business plan and meeting the requirements of investors for appropriate returns.

Striking this balance tends to manifest itself most in the form of heavily negotiated cashflow waterfalls, controls around the business plan and controls around disposals and allocation of risk through the representations and warranties.

Although there is no doubt that there is a real alignment of interests between lenders and sponsors to realise the most value possible from each NPL portfolio, the lenders should always have regard to the nature of each individual portfolio and its particular characteristics in putting together a financing package. For example, what may be appropriate in a very granular portfolio may not work from a senior debt perspective in respect of a portfolio where there is a high degree of value concentration in a small number of assets.

The typical structure of an NPL financing loan is that the initial debt amount is sized based on one or more day one financial covenants, such as a look-through loan to value, loan to purchase price or loan to recoverable value test, with the sponsor being required to fund the remaining purchase price through equity. That equity is typically advanced by way of a profit participating loan or other form of subordinated debt. The waterfall in the loan is then structured to strike the appropriate, negotiated balance between debt protection and profit for equity investors. While the portfolio is performing to plan and the sponsor is meeting or outperforming its business plan (tested through soft financial covenants) the waterfall will allow the sponsor to take the benefit of excess cashflows as equity distribution. Conversely, where the portfolio is not performing to plan, the senior lenders will want to ensure that the cash sweep triggers operates to ensure the senior debt is amortised. As the senior debt is limited recourse to the portfolio, the only protection available to the lenders is to allocate the risk as best they can to the sponsor's equity.

Over the last few years there has also been a trend towards simplification of the waterfalls. In the early days of the market, the loans contained release pricing concepts imported from real estate finance to ensure that the debt was amortised as quickly as possible when disposals were executed. In addition, the waterfalls contained various different financial tests and hard amortisation targets to ensure continued compliance with the business plan so that the senior debt was protected and the risk allocated as heavily as possible to the sponsor equity. The result was that where the sponsor over-performed on its business plan, the senior debt got repaid significantly more quickly than anticipated by the senior lenders. This has led to the more balanced approach currently taken by senior lenders, that has the benefit of reducing prepayment risk for senior lenders. That said, just because sponsors are over-performing on business plans in the UK or Ireland (with associated changes to financing terms), that does not mean those changes in financing terms will be extended elsewhere. Indeed, as sponsors and lenders enter new geographies there tends to be a tightening of debt terms on the first transactions until the state of the market, the quality of the assets and the returns to be expected, become clearer.

The same can be said of the representations, warranties and undertakings in the financing documentation. In the early days after the crisis many loans included asset representations given by the sponsors, regardless of the representations and warranties given to them by the seller in the SPA. Cash sweep concepts were then employed to amortise the debt where loans in the portfolio were in breach of the asset representations. Particularly in the more mature NPL markets it is now far less common to see these kinds of provisions, with the lenders relying instead on the overall financial covenant tests to monitor performance and business plan implementation on a portfolio-wide basis.

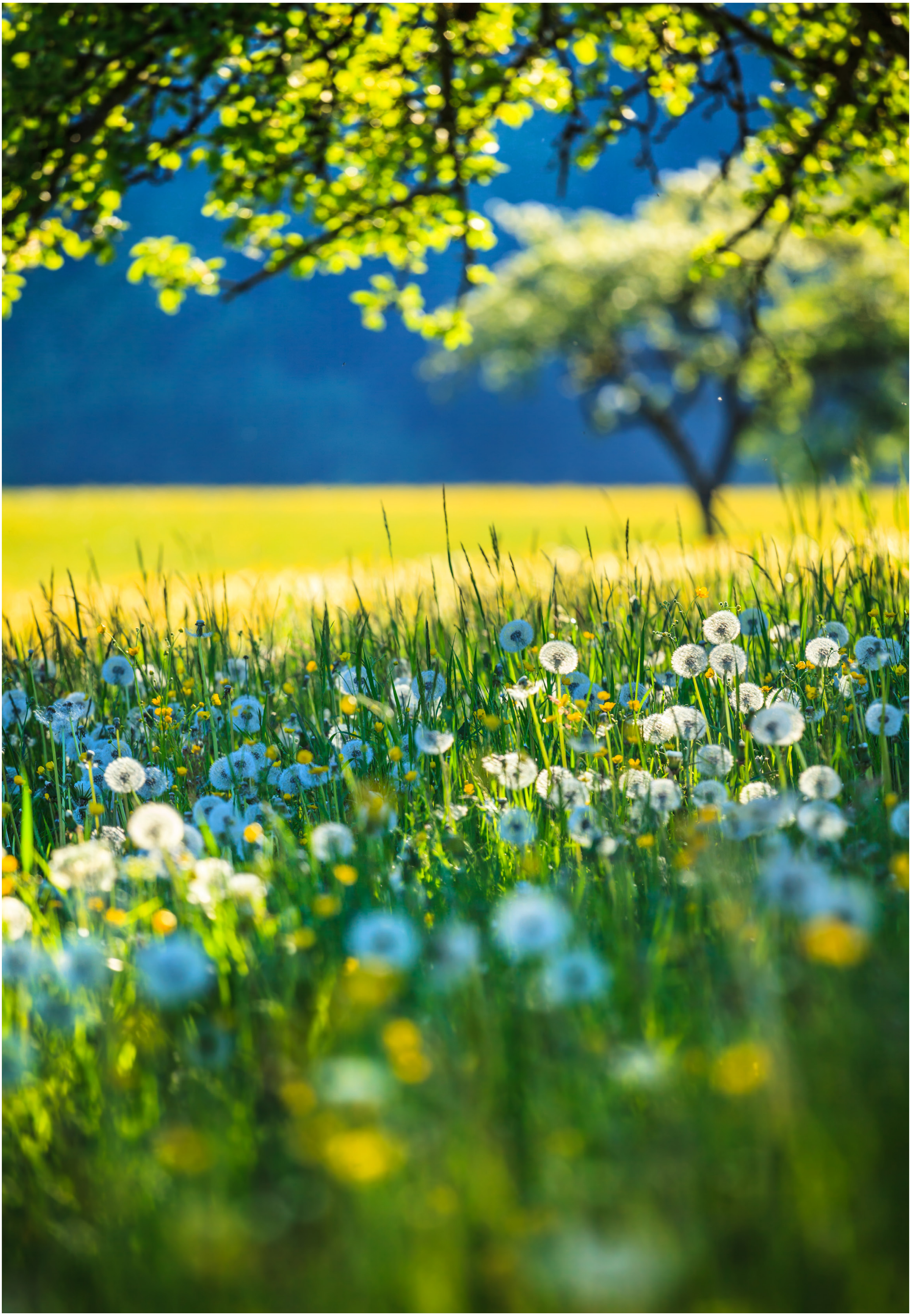
Trends in the residential mortgage portfolio market

By contrast with the commercial real estate and NPL disposal space, performing residential mortgage portfolio disposals in the UK and Ireland are currently tending to be financed largely through public securitisations at the point of acquisition. More traditionally, a loan-based warehouse financing might have been used initially, with an exit to the public securitisation markets when the conditions were right (and often once other portfolios had been acquired). While this model is of course still available and being used by some market participants, there has been a definite move toward skipping the warehouse phase in favour of an immediate public securitisation. For some deals, this is because the consortium of bidders for the portfolio includes bond investors unable or unwilling to take exposures in the form of loans. In these circumstances, loan-based warehousing is incompatible with the participation of such investors, making the public (albeit largely pre-placed) securitisation format a precondition to their participation. Another factor at play has been the size of the available portfolios. Portfolios often reach multiple billions each, as they represent exits from markets by existing lenders. Such jumbo disposals have been better suited to the public securitisation markets where their size is not as much of a limiting factor compared to the loan warehouse market.

The volume of residential mortgage portfolio disposals is also of note. While market participants will be familiar with the UKAR disposals of the remainder of the Bradford & Bingley and Northern Rock portfolios, there have also been other notable exits from the market. These have included Lloyds Bank and Danske Bank both exiting from Ireland, and UniCredit exiting the UK. All of these disposals have used public securitisation financings. Although these exits have provided a large and steady supply of portfolios coming to market over the past 18 months or so, only time will tell whether that supply can be maintained, and if other lenders will look to exit the UK and Irish markets. One other factor to be monitored closely is whether the proposed regulation of loan purchasers in Ireland will have a deterrent effect on participants in that market

Conclusion

As described above, the portfolio disposals market has been evolving at a fast pace over the last few years and there is no reason to suggest the pace of change will slow down. Turning specifically to NPLs, as regulators both in Europe and around the globe continue to push financial institutions to divest themselves of their large stocks of non-performing loans (see, e.g. our article on Chinese NPLs later in this publication), the volume of transactions coming to market is expected to increase. Demand from sponsors for these portfolios and the corresponding demand to provide the acquisition finance is expected to follow, particularly in jurisdictions where the market for non-performing loan disposals is in its infancy. As we have seen in past years, as non-performing loan markets have opened up, it is anticipated that sponsors and their lenders will take the techniques and experience acquired in the more mature non-performing loan markets to new jurisdictions. Across Europe, the market awaits the final legislative proposals from the European Commission and there will no doubt be a period during which current market practice adapts to these proposals if, as and when they are implemented. It is to be hoped that the European Commission can achieve its objective of delivering a robust and competitive secondary market for non-performing loans.



GREEN SECURITISATION: SECURITISATION GETS THE GREEN LIGHT

The increased political mandate and will to address environmental concerns will require a huge amount of investment by government and industry. Structured finance transactions can play a key role in financing these goals. We consider in this article what constitutes a green securitisation transaction and the challenges that will need to be overcome to develop a robust green securitisation market.

What is green securitisation?

Identifying what constitutes green securitisation will be key to the development of this market, its scope and role. There are three potential categories: (i) transactions secured by portfolios of green assets ("**Green Collateral Securitisations**"); (ii) transactions, the proceeds of which are ring-fenced for investment in green projects ("**Green Proceeds Securitisations**"); and (iii) capital relief securitisations, where the originator utilises freed-up capital to invest in green projects ("**Green Capital Securitisations**"). In respect of (ii) and (iii) it is not necessary that the underlying collateral be green. We consider what we mean by this term "green asset" in greater detail below.

Green Collateral Securitisations require a clearly identifiable portfolio of relatively homogenous green assets. There is the exciting potential for the growth of new asset classes and for green variations of existing asset classes to develop. We could, for example, soon see RMBS or CMBS deals secured on green real estate, such as the Dutch Green Storm RMBS transaction in 2016, which was secured on properties meeting certain energy efficiency requirements. Auto deals financing electric or hybrid vehicles are probably not too far away and there is the potential for a new "green loan" version of SME and consumer loan securitisations to develop.

Green Proceeds Securitisations and Green Capital Securitisations are potentially broader in scope as they are not restricted by the requirement of a pool of homogenous green assets. Recent examples include the US Toyota transactions, the proceeds of which were applied to fund the development of environmentally-friendly cars, the FlexiGroup deals (more details below) and the Premium Green synthetic securitisations by Crédit Agricole CIB which utilised capital relief for green purposes. A market for green covered bond and secured corporate deals (for example, in the water and waste management industries) could also develop.

To date the majority of green securitisations have been in the US and Asia rather than Europe. The market certainly has the potential for global scope and we note the recent green issuance we worked on with Bank of China in 2016.

What criteria are there for identifying green securitisation transactions in the current market?

A number of green securitisation deals have obtained verification of compliance with the green bond principles ("**GBP**") and climate bond standards ("**CBS**") from external reviewers, for example, the Obvion and FlexiGroup deals. The rating agencies have also introduced green bond assessment methodology (separate from the usual credit rating process) which evaluates the environmental credentials of originators and issuers.

Asset specific regulations are also relevant, and may be referenced in the eligibility criteria for Green Collateral Securitisations. Under European Directive 2010/31/EU, Member States are required to establish a system of certification of energy performance which formed part of the eligibility criteria on Obvion. There is also the Energy Efficient Mortgages Initiatives of the European Mortgage Federation and European Covered Bond counsel which aims at developing energy efficiency mortgages based on preferential rates. Finally, for vehicles, there are the emissions tests performed on vehicles for CO2 per g/km. However, accessing information about the green nature of underlying assets has historically been, and still is, difficult and the lack of this underlying data is causing challenges in the growth of this market. We note that it was only the recent release of EPC (energy performance certificate) data by the UK government that Barclays Bank cited as a key factor in its ability to launch, in September 2017, its green bond framework for the financing of energy efficient residential properties.

Structured finance as a form of financing for green assets

There are strong arguments in favour of developing a green securitisation market in Europe and the UK to help fund the demand for financing. Securitisation has a proven track record of financing these types of assets, providing ready access to institutional investors and reducing costs of capital.

Encouragingly, there are few legal or regulatory barriers to the development of a Green Proceeds Securitisation or Green Capital Securitisation market which utilise established asset classes, structures and techniques. All that is required is sufficient incentive for lenders to invest proceeds or capital relief in green assets, technologies and businesses, and investor demand for green securitisation bonds. We hope investors will increase their mandates to invest in green securitisations, and note with interest that the recent green bond issued by FlexiGroup (the proceeds of which refinanced solar power systems) priced slightly tighter than the non-green bond issued by FlexiGroup at the same time. Governments can also assist the progress of this asset class by introducing or expanding upon programmes that incentivise originators and investors – such as tax or regulatory capital benefits, or beneficial treatment by central bank financing schemes. The continued development of green criteria and labelling schemes will be critical if there are benefits to be gained in being labelled "green".

Green Collateral Securitisations give rise to additional challenges. As well as green variations of existing asset classes, there is the potential to develop new asset classes similar to recent deals in the US. Potential new asset classes are infrastructure deals and consumer and SME loans for the financing of green assets, for example, the installation of solar panels, renewable storage units or air cooling equipment.

Originators may also enter into equipment leases and power purchase agreements with customers where the originator retains title to the asset installed at the customer's property and the customer benefits from the energy produced. The US has also developed property asset clean energy programmes (known as "**PACE**") where municipal bonds issued by state entities or companies fund the installation of energy equipment, with payments on the bonds being funded by the relevant homeowner making an increased property tax payment. All these types of asset can be packaged up and securitised and examples include the SolarCity and Renovate America HERO deals.

What challenges do public Green Collateral Securitisations face?

The development of all aspects of a green securitisation market is dependent on the advancement of the industry as a whole, originator incentives and investor demand. However, some more specific legal and regulatory issues arise in the context of Green Collateral Securitisations. The first challenge for originators will be building a sufficient stock of relatively homogenous green assets to support a public securitisation.

The second will be how to deal with changing attitudes, regulation and policy in such a progressive industry, for example, who takes the risk of a change in what constitutes a green asset, what happens if government incentives are withdrawn or reduced and what happens if an asset you thought was green turns out not to be, noting, by way of example, the recent scrutiny around car emissions testing.

Although the quantity of green housing stock will grow as property developers harness green technologies for new build properties these assets will make up a relatively small proportion of the market. The development of a substantial green RMBS and CMBS market may depend on the success of programmes designed to upgrade the energy efficiency of existing real estate stock and government incentives. The upgrade programmes are more likely to be financed by consumer, SME loans or equipment leasing (which face their own difficulties, as to which see below) but an existing property, once updated, may then become eligible for a green mortgage loan.

Multi-originator transactions are a potential way of addressing limited stock for public securitisations but are often not popular with investors and require additional due diligence compared to other deals.

In the SME and consumer loan space, although we would expect loans to individuals to finance the installation of solar panels to be fairly homogenous, loans to enable businesses to install or develop green equipment or technologies may be more bespoke – less granular assets are often less suitable for securitisation.

These issues are less likely to apply to the development of a green auto market which is naturally homogenous and the amount of investment by the industry in the development of green technologies will hopefully mean these types of green securitisation transactions are not too far away.

Additional challenges to the development of Green Collateral Securitisations secured on green SME loans, consumer loans and similar underlying contracts

As mentioned above, the US has seen the development of some new green asset classes in the context of SME and consumer loans, equipment leasing, power purchase and PACE. These asset classes also give rise to some specific issues deserving of further consideration.

Taking security, enforcement and the identity of the underlying customer

It would be challenging to take valuable security over the majority of green assets financed pursuant to these underlying contracts. Green assets will often be tailored to a particular property or business and/or integral to the construction of the property, making it physically difficult or costly to remove the asset upon the enforcement of the underlying contract and meaning the asset has little or no value in the secondary market. The speed of technological advance in the industry also gives rise to a material risk that the green asset will become obsolete and of little value prior to the termination of the underlying contract. Many of these receivables will therefore either be unsecured or secured on another asset owned by the underlying customer. If unsecured, this will have an impact on recovery in the event investors wish to enforce under the securitisation deal, for example, by way of a portfolio sale. If secured on another asset of the underlying customer, for example, the relevant property, priority of security issues may arise if that asset is already secured (or may in future be secured) for another purpose, such as a mortgage loan. Similar issues arose in the US in connection with whether mortgage loan payments on loans purchased or underwritten by Fannie Mae and Freddie Mac were subordinate to increased tax assessment payments under PACE programmes.

There is also a risk that solutions designed to overcome commercial challenges for the industry will create new challenges from a securitisation perspective and restrict the development of this market. A common concern for potential customers is what will happen if they want to sell the property before the end of the term of the underlying contract. If the new purchaser is unwilling to take over the contract the customer would likely have to repay or buy out the remaining term of the contract in full at that time. To allay this concern the industry is incentivised to encourage a future purchaser of the property to assume responsibility for any remaining term, for example, by being able to demonstrate that the contract is cost efficient or by somehow linking the contract to the property. However, the fact that the underlying customer could change raises issues from a credit perspective for a securitisation, particularly if the loan is unsecured and the identity of the customer relevant to eligibility. The shorter-term nature of many securitisation transactions, the fact that any new customer should either own the property and/or have been approved for a mortgage and the fact that energy costs are likely to be a priority for any customer, helps mitigates this risk.

Feed-In Tariffs and credits

Feed-In Tariffs and credits are another example of potential conflict between industry concerns and securitisation concerns. Many governments support the introduction of schemes that allow owners of energy creating assets to sell excess energy back to the grid. As well as providing an incentive to make buildings more environmentally friendly there is the added benefit of reducing dependence on existing energy sources. An example is the Feed-In Tariff designed for solar panels in the UK. The party that directly benefits from the credits is the owner of the asset, whether that is a borrower that utilises a green loan to acquire a green asset or a supplier that enters into lease or power purchase contracts with customers. Depending on the structure of the particular arrangements, payments by customers on the underlying contracts may vary depending on the volume of excess energy available to be sold each month. Although these government-backed schemes incentivise customers to invest in green assets and therefore support the development of the industry as a whole, the application (and potential sudden withdrawal, reduction or limitation) of these schemes could make the income stream for any securitisation transaction unpredictable (unless the benefit of any credits were also sold into the deal). The risks associated with any removal or curtailing of these schemes during the life of the securitisation transaction would also need to be thought through. If originators and customers rely on the availability of these government-backed schemes any change in availability or applicability could impact on origination levels with customers and suppliers looking to other income sources to make up for any reduction in income.

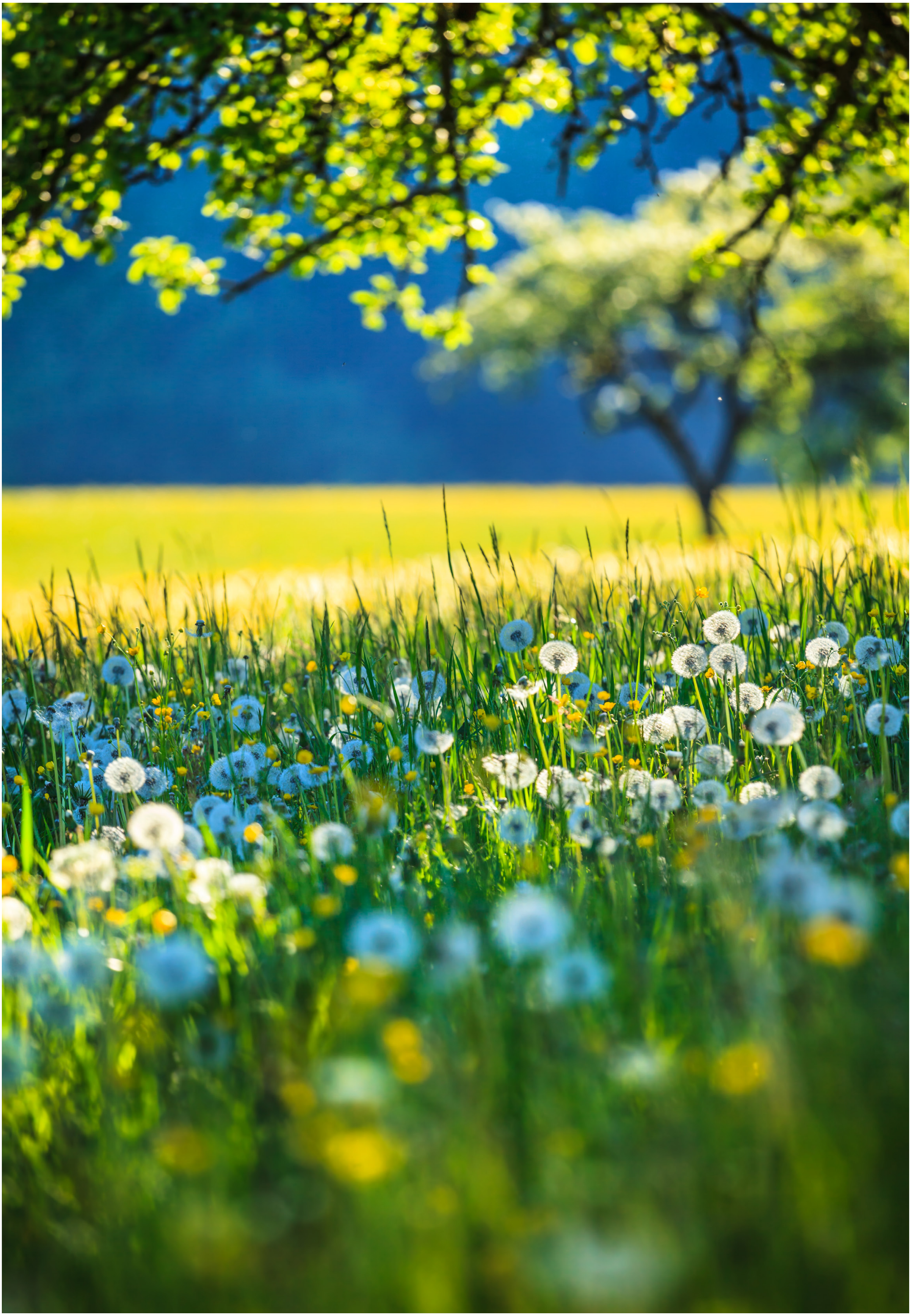
We note, by way of example, that access to the Feed-In Tariff in the UK was reduced by the UK government recently and it is expected to be phased out over time on the basis that the costs of installing solar panels have decreased and become more financially viable without this ongoing political support. Any changes in political will and government strategy in this new industry could have an impact on any securitisation deal, particularly while the industry and market is still establishing itself.

Reliance on the originator maintaining the asset

Any structured finance transaction for a green asset will also need to consider and structure for any capex requirements. We would expect some form of ongoing maintenance agreement to be entered into between the financing vehicle and the originator as well. The due diligence process will need to ensure there are third party maintenance providers able and willing to step into this role in the event the originator becomes insolvent.

Conclusions and next steps

We strongly welcome the development of a green structured finance market and hope it will become an important tool in the fight to meet growing demands and needs for financing green initiatives. There are a number of advantages to securitisation as a means of finance and many existing asset classes could be utilised to raise funds to invest in this market. Although there will be challenges that will need to be faced, particularly in the context of developing new asset classes, we look forward to the opportunity to work on many of these projects. In the short-term, we would expect to see more financing of green assets funded in the private warehouse space as the industry becomes more established. This will enable structures to be refined, track records established and problems solved, so as to open up the potential for public term securitisation take outs in time as the volume of assets and certainty over cashflows grows.



CHINESE NPLs: A ROLE FOR FOREIGN INVESTORS?

Although their absolute levels are still low, the stock of non-performing loans in China is on the rise, leading to a renewed focus on securitisation as a means of helping Chinese banks to manage their exposures. In this article, we review the structure of the Chinese securitisation markets, with a focus on the aspects of those markets open to foreign investors. We also reflect on the possibilities for an increased role for foreign investors in Chinese securitisation markets going forward.

The last wave of Chinese non-performing loan ("**NPL**") disposals took place in the late 1990s and early 2000s in a bid to "cleanse" the balance sheets of the major state-owned commercial banks, namely the Industrial and Commercial Bank of China ("**ICBC**"), Bank of China ("**BOC**"), China Construction Bank ("**CCB**") and Agricultural Bank of China ("**ABC**") – before their eventual floatation on the stock market. Back then, the most commonly used solution was to dispose of NPLs via the big four asset management companies ("**AMCs**"), namely, Cinda, Huarong, Great Wall and Orient. Each of the big for AMCs was set up to acquire NPLs from its corresponding commercial bank (as well as the state-owned policy bank, the China Development Bank ("**CDB**")) at book value.

According to official data released by the Chinese banks regulator, the China Banking Regulatory Commission ("**CBRC**")[1], the outstanding NPLs held by all domestic Chinese banks have now reached RMB 1.67 trillion (approx. USD 265 billion) as of Q3 2017, making up 1.74% of the total bank loan book. While high rates of NPLs persist in the mining, wholesale and retail trading sectors, most NPLs are in the manufacturing industry, particularly in light manufacturing, chemicals and construction materials. Slowing growth has had a significant impact on these sectors. In terms of regional distribution of NPLs, there has been some recent improvement in the most developed regions of the Yangtze Delta (Shanghai-centered) and Pearl River Delta (Guangzhou and Shenzhen-centered), while rates are continuing to rise in areas such as the Bohai Economic Rim and the Chinese north-east.

While official data shows that that the NPL ratio remains reasonably low, in relative terms the NPL ratio has recently swelled to a decade-high (which is correlated with the slowest economic growth in the last 25 years). As the Chinese government continues to curb industrial overcapacity and cut off financial support for loss-making borrowers, the volume of NPLs looks set to increase – which has put growing pressure on the balance sheets of domestic banks in the People's Republic of China ("**PRC**").

In this environment, the Chinese government has since 2016 begun looking at NPL securitisation again as a means to dispose of the increasing NPLs.

Current status of PRC NPL Securitisation

On 16 February 2016, eight PRC authorities including the People's Bank of China ("**PBoC**"), the CBRC and the National Development Regulatory Commission ("**NDRC**") jointly issued the *Several Opinions on Adjusting Industrial Structure and Improving Industrial Efficiency*, stating that a few qualified financial institutions would be selected to pilot non-performing asset securitisations. Shortly after that, a total quota of RMB 50 billion (approx. USD 8 billion) was granted to six major banks. Recently, the list has been further expanded to include twelve more banks with a mix of state owned, joint stock and mid-sized commercial banks. The 18 banks will share the original RMB50 billion quota.

In the last quarter of 2017, alone, there were ten Chinese NPL securitisations with a total issuance amount of RMB 6.8 billion (approx. USD 1.05 billion).

To date, Chinese NPL securitisations have been done through the credit assets securitisation scheme (as to which see our client briefing "An Update on Recent Developments in Assets Securitisation in the PRC"[2]), which permits international investors to invest in these instruments through the China Interbank Bond Market ("**CIBM**"), provided that they have completed a filing process with the PBoC. However, to date, investors that trade these instruments are mainly domestic commercial banks and AMCs; there is only minimal involvement of foreign institutional investors.

Chinese NPL securitisations are all public offerings on the domestic regulated market and have a relatively high standard of transparency. Nonetheless, the Chinese regulators have adopted a cautious approach towards NPL

[1] http://www.cbrc.gov.cn/EngdocView.do?docID=2C877F5F62694FC68A1C27AB46542A02

[2] https://onlineservices.cliffordchance.com/online/freeDownload.action?key=OBWIbFgNhLNomwBl%2B33QzdFhRQAhp8D%2BxrIGRel2cr GqLnALtlyZe1e3b4bsoBAildRWRmh9PYzp%0D%0A5mt12P8Wnx03DzsaBGwsIB3EVF8XihbSpJa3xHNE7tFeHpEbaelf&attachmentsize=101671

transactions and have published "enhanced" disclosure requirements around them. In April 2016, the National Association of Financial Market Institutional Investors ("**NAFMII**") published the *Guidelines on Information Disclosure of NPL-backed Securities (Trial)*, which contain enhanced requirements on information disclosure in respect of underlying assets as well as the capability and experience of the loan servicing banks.

Chinese NPL Structures

Public securitisation structure

From a structural perspective, a public PRC NPL securitisations follow very closely the paradigm PRC structure for credit assets securitisation. That is to say:

(i) The originator bank entrusts and transfers the NPLs (as the underlying assets of the securitisation) to a PRC trust company to establish a special purpose trust ("**SPT**"). The transfer will not be perfected unless and until certain title perfection events occur (e.g. termination of the loan servicing agreement).

(ii) The trust company (as trustee) will divide the beneficial interest in the trust into units ("**Trust Certificates**") and (through the underwriter) issue Trust Certificates to investors through the CIBM. The proceeds received from investors during the issuance process will in turn be paid to the originator as consideration for the entrustment of the NPLs.

(iii) The originator will continue to act as the loan servicer for the SPT and provide debt collection-related services (including handling court proceedings and enforcement procedures).

(iv) A third-party bank will be engaged to act as the custodian bank of the SPT to open and maintain relevant accounts and ensure cash flows generated by the underlying NPLs are ring-fenced.

The capital structure of PRC NPL securitisations is typically very simple, with senior debt issued to investors and equity retained by the originator. A limited number of transaction have mezzanine tranches. As with a common Chinese credit assets securitisation, there is no back-up servicer or back-up cash manager.

Private quasi-securitisation structure

Private regimes have also been developed for outright transfer of the ownership of NPL assets and/or a transfer of receivables arising out of NPL assets. These regimes may involve a private quasi-securitisation structure registered with a central credit assets transfer and registration centre ("**Registration Centre**") set up by the CBRC in 2014.

The most commonly used structure for a private quasi-securitisation is similar to a public PRC NPL securitisation. In this structure, the originator bank entrusts and transfers the NPLs to a SPT, which in turn issues the beneficiary interests (which may or may not be tranched) to a pre-selected list of investors. Alternatively the trust could be set up solely in favour of the originator (as settlor and beneficiary of the assets) which then "slices and dices" the trust interests and sells some parts of the trust interests to investors. The originator will normally retain a portion or all of the equity tranche of the beneficiary interests as credit enhancement. In contrast to the public credit assets securitsation transactions which are approved by CBRC and traded in the CIBM, these private structures are registered at the Registration Centre (which gives them some kind of regulatory oversight) but are not capable of being traded in the CIBM.

Unlike public securitisations issued through the CIBM, international investors are not, so far, permitted to invest in these private securitisations.

The upcoming introduction of new asset management rules in the PRC, announced at the end of April 2018, may affect the use of the private quasi-securitisation structure. While the focus of these new rules is to reduce regulatory arbitrage and tackle shadow banking and excessive leverage, it remains unclear whether they will affect the way in which Chinese banks seek to manage their exposure to NPLs or whether they will make certain NPL products less attractive to investors. As the guidelines which will accompany the new regulations are introduced over time, the broader consequences of the changes will become clearer.

Transfers of NPLs to foreign investors

Outright transfers of NPLs currently remain a monopoly of the AMCs, including the four central-level AMCs and the province-level AMCs which are permitted to be established according to a CBRC rule issued in 2013. The 2013 rule allows, subject to the prior approval of CBRC, each province to establish one or two AMCs for the purpose of acquiring NPLs within the territory of such province.

Foreign investors have been permitted to acquire NPLs from AMCs since 2001. Further legislation and guidance has been put in place since then to facilitate and control the sale of NPL pools to foreign investors. On 8 August 2016, NDRC issued a circular in respect of foreign debt management on the transfer of NPLs from domestic financial institutions to overseas investors. This circular clarifies what application documents are necessary in order to obtain an NDRC registration required in order to complete a sale of NPLs to a foreign investor.

In practice, acquisition of NPLs by foreign investors is often done via an offshore special purpose vehicle sponsored by the relevant foreign investors and typically involves the following steps:

(i) The commercial bank transfers the NPLs to an AMC through a bidding, auction or other public sale procedure. Due diligence (legal, financial and valuation), and purchase agreement negotiations will both be conducted at this stage, sometimes concurrently.

(ii) The AMC, in turn, transfers the NPLs acquired to other investors through a similar bidding or auction process.

(iii) Where a foreign investor is selected as the purchaser, the AMC must register the sale with the NDRC as set out in the 8 August 2016 circular.

(iv) In addition to the registration with the NDRC, the AMC (for the purpose of receiving the purchase price) and the foreign investor (for the purpose of remitting the proceeds of NPLs collections offshore) may be required under local rules to register with the State Administration of Foreign Exchange ("**SAFE**"). The nationwide SAFE registration requirement was removed in early 2015.

The registration with NDRC mentioned above is of vital importance. In order to obtain this registration, a package of files must be submitted to NDRC for review. These files include (i) a description of the transfer, (ii) the purchase agreement, (iii) details of the NPLs, (iv) proof of identity of the foreign investor, (v) a notarial certificate in respect of the transferr process, and (vi) a legal opinion issued by a qualified PRC counsel. Only after the AMC receives the registration certificate from NDRC can the AMC and the foreign investor proceed with the SAFE registration (where required) and the corresponding currency conversion and remittance of funds. According to the NDRC's list of registrations[3], each of the 4 central-level AMCs has transferred certain packages of NPLs to foreign investors, though no details of such transfers were published.

While the acquisition of NPLs by international investors, strictly speaking, is required to go through two separate bidding processes, we understand that in practice, AMCs are typically used as "conduits" if foreign investors are interested in a specific portfolio of NPLs. Foreign investors can, in this sense, diligence and assess, and to some extent select, a pool of Chinese NPLs they wish to acquire.

Structural impediments to foreign investment in Chinese NPLs

Some commentators have compared Chinese NPL securitisation with the Italian experience of using securitisation as a means of addressing rising NPL problems. However, unlike the more developed NPL markets in Europe, there remain a number of impediments in China to using securitisation as a method of addressing issues with non-performing loans.

The first impediment is the lack of clear debtor resolution, insolvency or rescue regimes. The Chinese government has made it clear on a few occasions that, unlike the first wave of NPL disposals, market forces will be allowed to play a greater role in the process this time around and NPL disposals would need to be undertaken in a market-driven manner. That said, there has been little desire to "tidy up" the often murky law and regimes in connection with taking action against a defaulting debtor, which creates uncertainty for foreign investors as legal uncertainty makes it difficult to model the possible outcomes of NPL portfolios. Contrast the recent developments in Italy where the Italian government has published a number of laws that seek to reform the legal and insolvency process to promote the resolution of NPLs. While it will take time for the full effect of these new Italian laws to be absorbed, they do provide certainty which can be factored into valuation and financial modelling.

The second impediment is the lack of a developed servicing infrastructure. Typically in outright transfers, the Chinese banks remain as the loan servicer on behalf of the relevant AMC for a transitional period. The AMC, in turn, will act as the loan servicer for the ultimate purchaser of the NPLs according to the loan servicing agreements (if any) between them. While the AMCs possess, by far, the deepest domestic special servicing and workout experience, their servicing practice is often opaque. Obtaining any sort of meaningful business plan or work out strategy in respect of the assets can be difficult. In practice, we understand the AMCs typically outsource the servicing to sub-contractors and it is common to have several layers of sub-contractors. By contrast, foreign investors – and particularly those familiar with the European market – would typically use their own team to monitor, and often drive, the servicing process. A lack of transparency in the workout process is likely to cause compliance issues with both a foreign investor and their financier. Further, from a liability perspective, any foreign investors wishing to avoid taking responsibility for the activities of the loan servicers would need the servicing arrangement to be carefully crafted such that they do not have vicarious liability – a difficult task where servicing is opaque. The vicarious liability issue is particularly relevant in the context debt collection practice as it is currently illegal in China to set up debt collection companies and certain debt collection activities are strictly forbidden.

The third impediment to the use of securitisation to work out NPLs in China is the lack of a transparent and efficient enforcement process. Again, this is not a new issue for China – enforcing commercial judgments is notoriously difficult in China, not least owing to the government's protectionist attitude towards local enterprises and the lack of an independent judiciary. Political influence, legislative loopholes and an

[3] http://www.sdpc.gov.cn/fzgggz/wzly/wzgl/

understaffed judiciary are also among the many issues impeding effective enforcement in China.

The fourth impediment is tax leakage. An outright transfer of NPLs will also involve complex tax issues. Foreign investors (as the purchasers of NPLs) will typically be subject to a withholding tax in respect of loan collection proceeds. Under current PRC tax regulations, the withholding tax rate is 10% if the relevant foreign investor does not have a permanent establishment ("**PE**") in China or the relevant incomes have no actual connection with such an establishment. Having a PE is not, however, a clean solution, since having a PE itself entails tax consequences. Notably, the foreign investor's profit attributable to the PE would be subject to 25% corporate tax. Salaries of any employees working in the PE are also subject to tax, regardless of their duration of stay in China.

Market forces affecting foreign investment in Chinese NPLs

Anyone wishing to invest in Chinese NPLs will need to think hard about the types of assets that can realistically generate returns and the liquidity of the domestic Chinese market. Taking real estate as an example – real estate in any prime locations are hotly pursued by domestic Chinese investors and there is never lack of domestic liquidity for such assets. By contrast, non-prime real estate (whether commercial or residential) is unlikely to generate any meaningful return.

Despite some encouragement from the PRC government on the securitisation of NPLs, market take up by foreign investors has not been great so far. As mentioned above, at the moment most Chinese NPLs are recycled within the domestic financial markets where there is very little focus by investors on the workout and enforcement regime or the servicing infrastructure for different asset types.

Aside from NPL securitisations and sales to AMCs, account also needs to be taken of the other channels available to Chinese banks for dealing with NPLs – for instance, they may be refinanced domestically through wealth management products, asset management plans, entrusted loans or other financial engineering techniques using off-balance sheet vehicles. While this range of other NPL management options remains open to Chinese banks, there is less incentive for NPLs to be put into the distribution channels open to foreign investors.

The two channels through which foreign investors can participate in NPLs are heavily affected by the existing market structure. More particularly, investing through the CIBM in a Chinese NPL securitisation provides a fixed return – the deep domestic market for these transactions results in only a tight spread being available to investors. Further, as the only source of special servicing in the market, and in the absence of demand from domestic purchasers of NPLs for change, there is little incentive AMCs to update their processes or systems and adhere to more detailed loan servicing guidelines or more actively monitor the subcontractors they use.

The future for foreign investors

There may be some value in foreign investors testing the market by taking limited exposure to Chinese NPL securitisations or directly acquiring pools of NPLs which may have more stable recovery prospects. That said, there is likely to continue to be only limited foreign investor participation until the issues mentioned above are addressed.

To that end there have been some recent developments which may be of interest to foreign investors:

More limited NPL distribution channels

There are new regulatory reporting requirements for wealth management products, limits on the levels of NPLs which wealth management products can fund and limits on leverage for asset management plans. The news, in January 2018, that Pudong Bank was hiding large exposures of NPLs through these types of products will also lead to further scrunity of them. This may, in turn, result in NPL securitisation and portfolio acquisitions becoming more trusted methods through which Chinese banks can manage their NPL exposure.

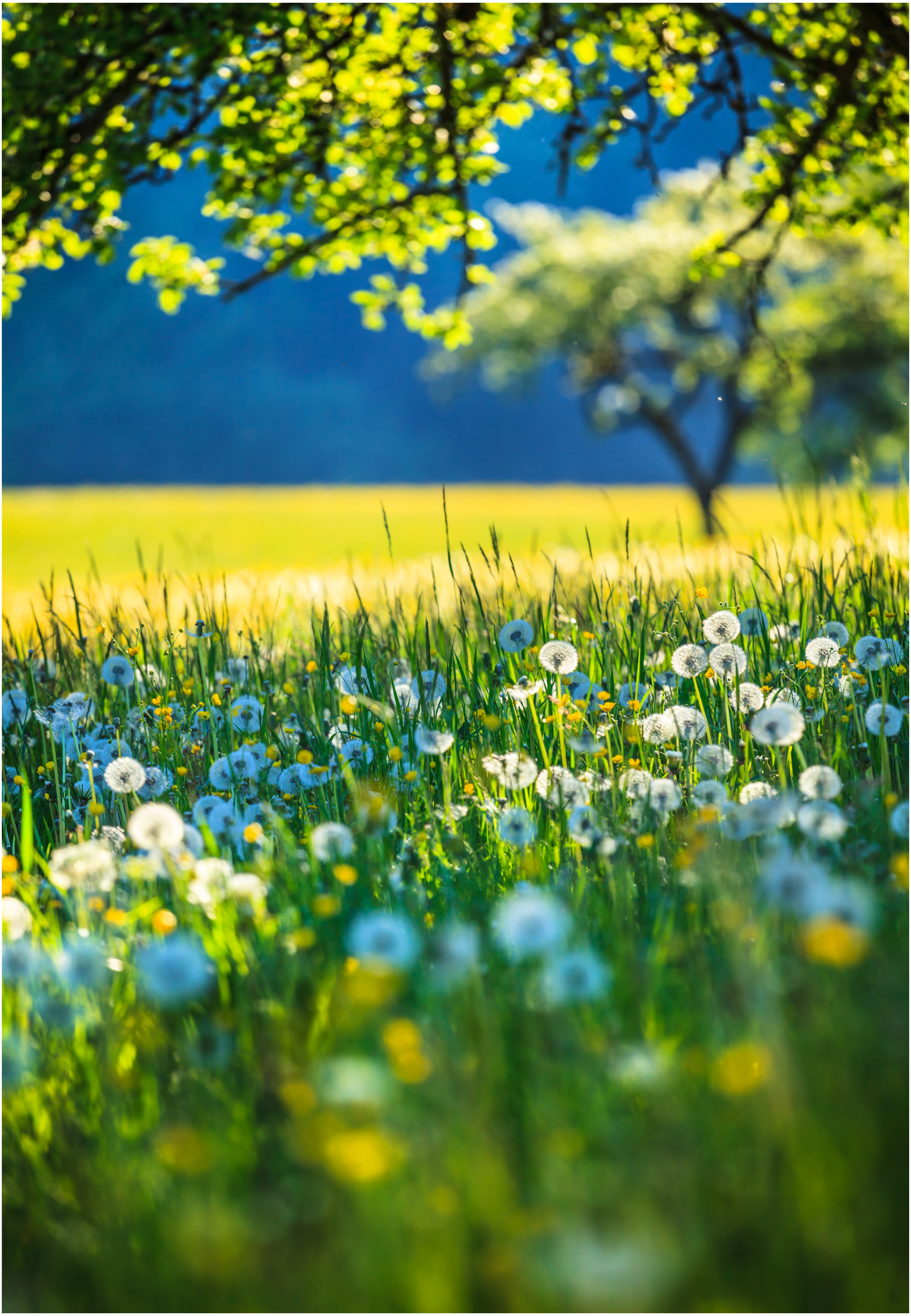
More competition between AMCs

In the IMF's December 2017 Financial System Stability Assessment of the PRC, the increasing role of province-level AMCs was noted and the increased competition they provided to the four central-level AMCs was highlighted. While this may push up the price of NPLs, it may also create a more competitive market for servicing, allowing foreign investors seeking to appoint a servicer a wider range of alternatives and an incentive for AMCs to provide a higher and more transparent level of service.

Adoption of debtor resolution, insolvency and rescue regimes

While it is only a first step, the NDRC's announced in January 2018 that it will support, in a market-oriented manner, the use of debt-to-equity swaps by private and foreign-funded firms. It may also be possible to create creditor committees to renegotiate loan terms. Companies which have long term potential may consequently survive, rather than failing unnecessarily due to a temporary default. This type of debtor rescue scheme will provide a degree of additional certainty in respect of how pools of NPLs, including debtors of this type, will perform over time.

While the immediate impact of these developments may be limited, each is a sign that the Chinese NPL market is changing in a manner that may make it more attractive for foreign investors and may, in time, provide a greater supply of NPLs in which foreign investors can invest.



BLOCKCHAIN AND SECURITISATION: RADICAL CHANGE ON THE HORIZON?

2018 has been dubbed the "Year of the Corporate Blockchain Wave."[1] Predictions about the extent to which blockchain technology will affect financial markets vary widely. Some commentators proclaim that blockchain will radically disrupt entire industries while others claim its benefits have been overhyped and that it is a solution in search of a problem. While use of blockchain has been discussed on deals in the securitisation markets, we are so far not aware of it actually being used as yet. In this article, we explain what blockchain is and consider ways in which it may be applied to securitisations – and whether that means radical change is coming.

How blockchain works

A blockchain is a type of distributed ledger. A distributed ledger is a shared set of records that is stored in decentralized fashion by each member of a group of ledger participants. Such participants are known as "nodes". In a typical blockchain, after all the nodes reach a consensus that updates to their shared record are valid, the record is updated in time-stamped chronological order on the blockchain. An update could be to record that the ownership of an asset has been transferred, or that the characteristics of an asset have changed, or that a payment has been made – the type of data that can be stored on a blockchain is virtually limitless and so the types of related updates is similarly broad. The consensus-based validation scheme required to update a typical blockchain record is in contrast to the way in which updates to traditional records are made exclusively by a trusted record keeper, such as a bank or custodian, who holds a single, central copy of the records. However, as discussed below, we question whether securitisation blockchains will operate with consensus validation.

Because all participants in a blockchain can view the shared ledger, or "golden record", and because new updates are validated and added in real time, there is no need to engage in reconciliation processes to bring the records that each node holds into conformity with each other, as there is where each transaction participant maintains separate records. The fact that all participants in a ledger are on the blockchain, and that the digital "golden record" is always accurate and up-to-date, can also streamline and speed up transactional workflows by eliminating the need to secure offline consents or approvals from geographically dispersed stakeholders or to compare offline paper records that may be stored in different locations or databases. In addition, because each node stores its own copy of the shared ledger, there is no single point of failure as there is when data is stored in a single centralised database. This makes the ledger resilient.

"Permissioned blockchains" can place restrictions on who can be a node, as well as restrictions on which nodes can access particular data points. This is in contrast to open-to-all blockchains, such as Bitcoin, and is a crucial distinction for ABS transactions that contain commercially sensitive information and which may contain non-public personal information about individuals. We expect that – if, as and when blockchain technology is introduced to securitisations – only permissioned blockchains would be used.

A data point, once added to a distributed ledger, can typically only be changed with extreme difficulty (such as so called "forking"), which makes the data stored in the ledger effectively immutable, increasing confidence in its integrity.

The advantages of using blockchain are therefore generally considered to lie in its potential to simplify and streamline operational processes, eliminate intermediaries, reduce the amount of time needed to complete transactions ("latency"), enhance transparency, and improve the integrity of data and records. Securitisation transactions, with their multiple parties, a wealth of asset data and increasing reporting requirements could benefit from such improvements. We will now consider some specific areas where improvements could be realised.

Shared records

Each participant in a securitisation (for example the investor, originator, servicer, custodian, trustee, paying agent, registrar, arranger or rating agency) typically maintains its own records and models and relies on periodic reporting from other participants for current data with respect to the transaction.

Maintaining these separate records and models can result in duplicative processes, increases the potential for inconsistencies between records held by different parties and can create latency while one party updates its records based on a report provided by another party. A shared ledger could eliminate such problems.

[1] Todd McDonald, Co-Founder of R3, *The Corporate Blockchain Wave,* https://medium.com/corda/the-corporate-blockchain-wave-72e3175f1449

If we use the example of a residential mortgage loan, the material terms and characteristics of the loan could be recorded on a blockchain in a 'token', which in this context essentially means an electronic file containing information about that loan which is stored in the shared set of records on the blockchain. Information recorded in this manner could include the principal balance, term, interest rate, priority of the mortgage, loan to value ratio, property address, insurance details or any other characteristic of the loan and collateral that is desired.

Proponents of blockchain technology foresee a future where a token will be created to record all relevant information about that asset at the point of the asset's origination. Thereafter, the token will then travel with the asset as its ownership is transferred, providing a permanent, immutable historical data file for the asset. We think this would require a widespread adoption of blockchain technology that is only likely in the longer term. In the nearer-term, there may be more potential for loan data to be added to a blockchain for a pool of loans that has been identified for a particular securitisation as part of the initial arrangements made in preparation for that transaction.

We are also skeptical that consensus validation by all nodes on a blockchain would be used for securitisations. Rather, the permission and ability to update certain data points in a token would have to be granted only to the party that has requisite knowledge; for example, a servicer should be able to record a loan modification but it makes little sense to require the paying agent's validation in order to update the related token; the paying agent will have no knowledge of the modification. In that sense, blockchains in securitisation transactions may operate as central, shared records but likely will still be updated by the relevant parties rather than by the consensus of all nodes.

Advantages of shared records

From an operational perspective, a central record that is available to all parties could help create operational efficiencies. For example, it might allow a paying agent to know what collections are available for distribution on a payment date without waiting for a servicer report. There are also blockchain-focused companies that have been working towards automating the cash flows of securitisations. Using collection information, note balances, coupons and fees and expenses due (all details that would be stored on the blockchain) they aim to automatically generate payment reports that set out the payments to be made on each payment date.

Other companies go further and are working towards a shared blockchain with a smart contract that would automatically run deal waterfalls and effect payments. A "smart contract" is a computer code that is embedded into the blockchain and runs a computer program. In this case, a smart contract would be programmed to apply collections in accordance with the pre-determined priority of payments. This could remove certain intermediary functions from transactions. If all parties to the deal were using the same blockchain, it would also eliminate the risk that their separate proprietary models for the waterfall may inadvertently have different terms and behaviors. In addition, triggers (including ratings triggers) could be embedded into the code to flag if the transaction is diverging from modeling forecasts or assumptions.

In addition to operational efficiencies, as lawyers, we see potential advantages from a legal perspective.

Reporting requirements: With a central record that contains granular information about every loan in a securitisation, compliance with asset level reporting requirements such as Reg AB II, central bank loan-level data requirements, or the coming loan-level data disclosure requirements under the EU Securitisation Regulation could all be near-automated. It would also be easier to monitor compliance with loan-level representations and to track and report breaches of such representations and related buybacks because the characteristics of a loan and the ownership of the loan would be recorded on the blockchain.

Any shared ledger would, however, have to be carefully constructed to ensure that only parties who need to (and are legally allowed to) see particular information have access to it. Concerns about the handling of commercially sensitive and/or non-public personally identifiable information that already exist in traditional deals will only be amplified if data is stored on a shared ledger to which multiple parties have access. Needless to say, the data protection implications under the EU's General Data Protection Regulation ("**GDPR**") would need to be carefully considered and managed. In the event of any mishandling of information on a shared ledger, it will be necessary to determine which party is legally responsible as concepts such as that of a data "controller" under the GDPR would continue to apply.

Title: There are already examples on local levels of title to real property being recorded and transferred on blockchains. If this were to become the norm, it could greatly simplify the process for transferring title and make securitisations more efficient. In jurisdictions where beneficial title, rather than legal title, is initially transferred to an issuer, there would still be advantages to having the token for a loan easily updated to note the new beneficial owner.

Collateral Pledge: Although not a widespread problem, there have been instances where assets have been fraudulently pledged to more than one creditor. If a token was created for each loan, and systems were designed such that it was only possible for one token to exist for each loan and each token contained a flag if the loan had been previously pledged, that would create greater certainty in respect of collateral pledges. A smart contract could go further and make it impossible to pledge an asset that had already been pledged.

Securities clearing

General capital markets infrastructure could also be changed by blockchain technology and used in securitisations. For example, rather than using traditional clearing systems to hold global notes and effect secondary trading, ownership of securities could be recorded and updated on a blockchain. Jurisdictions such as Delaware have already passed laws to expressly permit an issuer to issue securities that are evidenced solely by a record on a blockchain. There are a number of complexities associated with such a development that are outside the scope of this article – for example, whether geographic transfer restrictions could be adequately policed – and which mean that we expect the existing infrastructure to remain for the foreseeable future.

Hurdles to the adoption of blockchain in securitisations

The single biggest hurdle to blockchain's adoption in the securitisation industry is the fact that it remains untested as an enterprise-grade platform. This does not mean that blockchain is a purely theoretical construct that has never moved past the proof-of-concept stage but permissioned, financial industry consortia do not yet have a time-tested track record of reliable operation. Before blockchain can be widely adopted in the securitisation industry, it will need to win the confidence of all stakeholders and market participants that it is a credible alternative to existing systems.

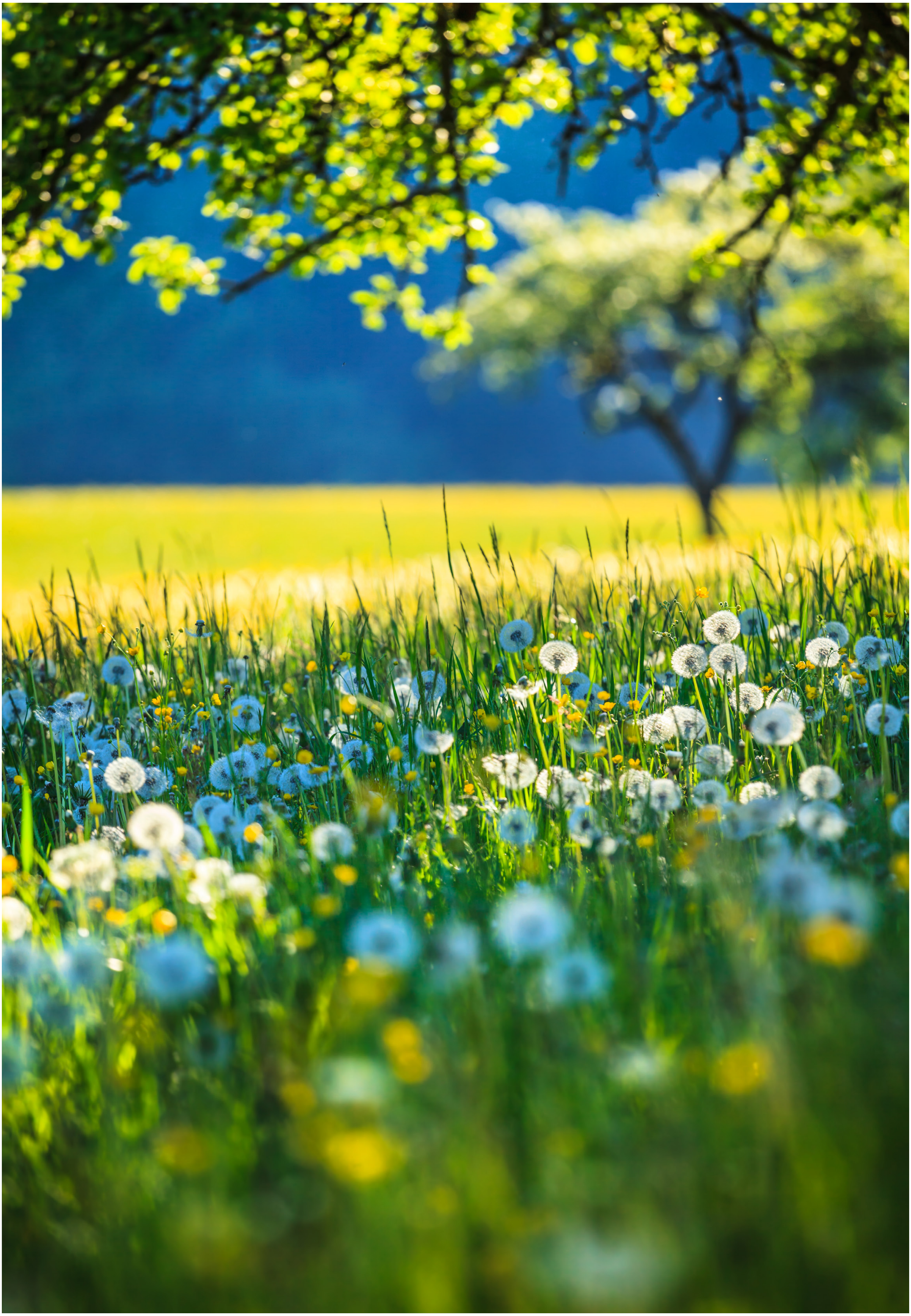
Interoperability and common data standards will also create challenges. What degree of compatibility, for instance, would new blockchain-based securitisation software have with existing financial industry legacy software platforms? If there is no compatibility between old and new, many efficiencies would be lost; non-interoperable software platforms would be as incompatible as analog systems are to digital ones.

Likewise, different blockchains would have to be able to talk to each other if asset tokens are to be able to travel from, say, an originator's blockchain to a warehouse blockchain to a securitisation blockchain. There are a number of interoperability protocols in development. For blockchain to be universal, one such protocol will have to prevail and be adopted universally. The analogy of the shipping container is a good one: before the adoption of a simple, standardised shipping container, goods had to be unloaded and reloaded between truck, train and ship and then again in reverse when they reached their destination. The humble shipping container revolutionized that process, allowing goods to be packed up at source and transferred seamlessly. Separate blockchains represent different ports before the shipping container. A simple, standardized protocol will be required to allow data to move freely between different blockchains.

Conclusion

So is blockchain technology something that will radically disrupt the securitisation industry or is it an overhyped solution in search of a problem?

It may be both: in the short- to medium-term, a shared ledger could be used to make legal compliance more efficient and accurate and it could eliminate certain operational processes and intermediaries from securitisation transactions. However, that makes blockchain only a slightly better toolkit which market participants can use to do things incrementally better than they are done today. More far-reaching disruption will require asset data tokens, interoperable blockchains and smart contracts, all of which are longer-term propositions. Change is coming but it seems unlikely that it will be radical…yet.



THE US RMBS MARKET: A PRIMER FOR NON-US MARKET PARTICIPANTS

Demand for, and supply of, US residential mortgage-backed securities ("**RMBS**") has been increasing in recent years, with the number of issuances rising and outlooks favourable for continued growth. As post-crisis deal volumes have increased, market conventions have crystallised such that market participants look for – and expect – certain structures and deal features in a US RMBS transaction. This article discusses and explains certain aspects of the US RMBS that non-US market participants making their first forays into the US markets may not be familiar with.

Mortgage loan origination and the primary market

As elsewhere, the US mortgage market has two segments: the "primary market," in which mortgage originators extend mortgage loans directly to the borrower, and the "secondary market," in which the mortgage loans originated in the primary market are sold to loan investors. Each of the primary market and the secondary market is highly dependent upon the other. In particular, a deep and liquid secondary market is essential to the primary market and the efficient functioning of the housing market in general. So far, this is no different to the European market but different characteristics lie below the surface.

Mortgage loan origination

In the US, the primary market consists of a mortgage loan originator (a lender), which may be a bank, a credit union or a finance company, extending a mortgage loan to a borrower. Lenders make various types of mortgage loans, including:

(i) Fixed-rate mortgage loans: Fixed-rate mortgage loans are by far the most common type of mortgage loans made in the primary market. In a fixed-rate mortgage loan, the borrower agrees to a fixed recurring payment (usually monthly) *for the life of the mortgage loan*. In contrast to the European market, lengthy fixed rate periods (such as 30 years) are commonplace in the US. Monthly payments are typically applied to both principal and interest, reducing the total balance of the mortgage loan with each payment.

(ii) Adjustable-rate mortgage loans: An adjustable-rate mortgage loan ("**ARM**") does not contain a fixed interest rate for the duration of the mortgage loan, but rather has an interest rate that fluctuates by reference to a pre-determined index. Commonly, there is a period of time at the beginning of the mortgage loan where the interest rate is fixed, following which the interest rate will adjust at specified intervals based upon the reference index. In this sense an ARM is similar to a UK loan that has a fixed teaser rate and then reverts to a standard variable rate.

(iii) Balloon mortgage loans: A balloon mortgage loan is a mortgage loan that requires a large lump-sum payment (usually representing a significant portion, if not all, of the loan's principal) at a specified date. A balloon mortgage loan can be structured so that the borrower makes either no payments or only makes interest payments up until the time of the lump-sum balloon payment.

The role of GSEs in the primary market

A significant differentiator for the US primary market is the presence of government-sponsored enterprises ("**GSEs**"), which are private institutions that have been chartered by the US Congress and are given certain favourable treatment. The Federal National Mortgage Association ("**FNMA**," commonly called "**Fannie Mae**") and the Federal Home Loan Mortgage Corporation ("**FHLMC**," commonly called "**Freddie Mac**") are two such GSEs. Fannie Mae and Freddie Mac were chartered to help develop the secondary market (discussed further below), but their outsized presence in the secondary market gives each GSE a strong influence over the primary market.

The role of the GSEs is to provide borrowers in the US with access to reliable, affordable mortgage financing throughout the US at all times, which they do by providing liquidity to lenders and expanding the secondary market by purchasing mortgage loans from lenders and securitising the loans. The presence of the GSEs has a distorting effect on the US market when compared against markets without such participants, as the GSEs' respective criteria for buying loans and their buying power help shape both the primary market and secondary market. The criteria used by the GSEs have become a standard for mortgage loan originations. Mortgage loan originators originate loans they know will conform to GSE criteria, as the execution with GSEs will be better than execution in the private market. Mortgage loans that meet GSE criteria – which include minimum credit scores of borrowers and a cap on the principal of the loan – are referred to as "conforming loans". Any lender who wishes to sell its mortgage loans to the GSEs must ensure that its loans are conforming loans.

Naturally, not all mortgage loans can be conforming loans. Some examples of nonconforming mortgage loans are loans for which the principal of the loan exceeds the cap imposed by the GSEs (so-called "jumbo loans") and loans for which the creditworthiness of the borrower is below that accepted by the GSEs ("alt-A" and "subprime" mortgage loans). For such nonconforming mortgage loans, lenders who wish to sell their mortgage loans must turn to private purchasers, who may then securitise them for sale in the secondary market.

Mortgage loan purchasing by private purchasers

Depositors

Unlike UK deals in which securitisation issuers are typically orphan entities, US issuers are typically owned by funds or other corporates. Also unlike in the UK, US law has the bankruptcy doctrine of substantive consolidation. If an entity is insolvent, this doctrine allows a court to determine that a purportedly separate entity is, in fact, one enterprise with the insolvent entity and the two should therefore be substantively consolidated with the effect that the assets of the related entity become pooled with those of the insolvent entity. To address bankruptcy concerns at the parent level, the parent will create a subsidiary entity referred to as a "depositor." The depositor is a special-purpose entity, with restrictions on its activities which are designed to make the depositor bankruptcy-remote. These restrictions will be familiar to non-US securitisation professionals: it is restricted from assuming debt, cannot voluntarily file for bankruptcy and has its purposes limited solely to activities relating to its ownership of mortgage loans.

The parent will then transfer the mortgage loans to the depositor. It is customary practice for issuers to deliver a "true sale" opinion with respect to this transfer, which helps to isolate the depositor's assets from those of the fund following the transfer. If the parent files for bankruptcy and the depositor has complied with its special-purpose covenants, then the assets of the depositor should not be included in the parent's bankruptcy estate.

Tax "blockers"

Certain US RMBS are structured to include an additional entity, referred to as a tax "blocker," that is a subsidiary of the issuer. Consistent with their name, tax blockers are generally used to "block" adverse US tax attributes of the issuer from flowing through to equity investors in the issuer. Tax blockers are formed as corporations and are not "pass-through" entities. They are typically used where the issuer may be engaged in an activity that is or could be considered engaging in a trade or business in the US. If the issuer is structured as a pass-through entity, the issuer itself might not be subject to taxation as a result of such activity, but the equity investors in the issuer generally would be treated as engaging in that same activity because of the pass-through nature of the issuer and may suffer adverse US tax consequences as a result. One such activity of concern to foreign investors in the equity of the issuer is the issuer's disposition of US real property (such real estate is commonly referred to as "REO"), which may have been acquired in connection with the foreclosure on the related mortgage loan.

As discussed below, "REMICs" can minimize the need for tax blockers.

Title

UK RMBS transactions typically transfer beneficial title to loans to the issuing entity, with legal title only being transferred upon the occurrence of a perfection event. This is done to save on the time and expense that is involved in notifying the underlying borrowers that the title to their loan has been transferred, which is a requirement for legal title to be transferred.

The US RMBS market has a similar concept in transactions that utilise so-called titling trusts to mitigate the need to re-title loans. In many states, purchasers of, and investors in, residential mortgage loans need to be licensed by the state in order participate in the mortgage loan market. This licensing process is often lengthy, intrusive (examinations of financials and background checks are common) and must be repeated annually. The titling trust is therefore used as an alternative to such licensing requirements. In such transactions, once loans are transferred by the parent to the depositor, the depositor will (usually instantaneously) deposit the mortgage loans into a titling trust formed by, and wholly owned by, the depositor, with a national banking association as trustee. The titling trust will only hold bare legal title to the mortgage loans, thus shielding the purchasers and investors from state-level licensing requirements.

Often, but by no means always, the beneficial ownership of the mortgage loans so deposited in a legal title trust (such as the right to receive payments and servicing rights) will then be passed, in the form of participation interests, to one of several subsidiary trusts. Because the holder of the participation interest does not hold legal title (as that remains with the legal title trust), there is no licensing requirement for the holder.

Each of the depositor, the titling trust and the subsidiary trusts are structured to be "pass-through entities" for US tax law.

As discussed above, many transactions only want to hold real estate (REO) in a blocker but it is not possible to re-title a loan in the instant it is foreclosed upon and converts to real estate. Therefore transactions often provide that the title to a loan should transfer to a blocker when a pre-determined delinquency trigger is met, such that foreclosure is becoming probable but has not yet commenced. It is important that foreclosure has not yet commenced because the law governing foreclosure procedures (which varies from state to state in the US) commonly provides that if a loan is re-titled any foreclosure process that has commenced has to be re-started following re-titling, thereby prolonging the time required to ultimately realise upon the asset.

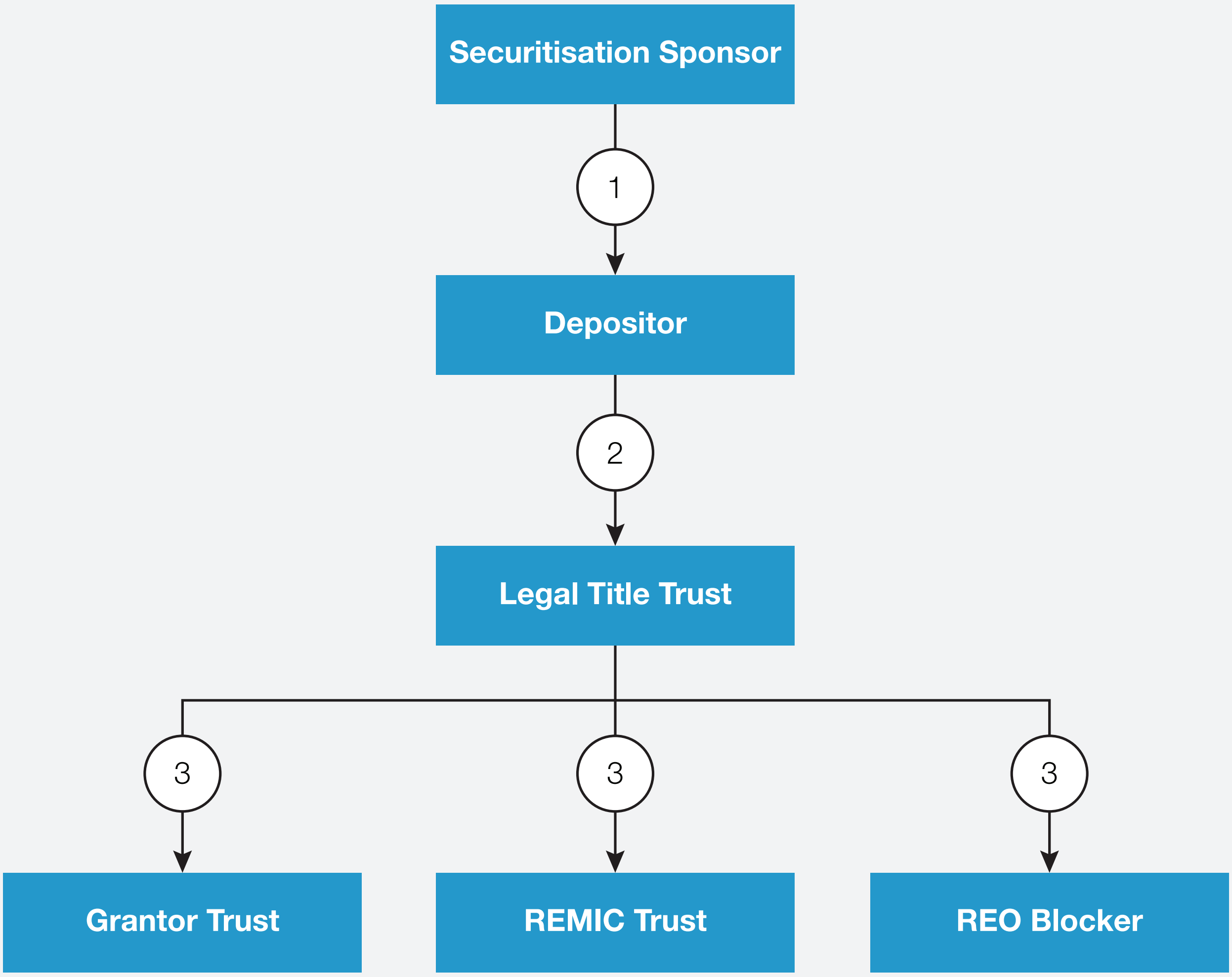
Mortgage loan securitisation and the secondary market

Whether performed by the GSEs or by a private sponsor, mortgage loan securitisation in the secondary market in the United States is essential to the efficient functioning of the primary market.

In US securitisations, it is common to see a structure whereby the mortgage loans are transferred from the securitisation sponsor to the depositor, and thereafter from the depositor to the issuer.

Prior to the development of a robust secondary market, mortgage loan origination was primarily performed solely by banks and savings and loan institutions, who held the mortgage loans on their books until maturity. The growth of the secondary market increased competition in the primary market, opening the door to a greater variety of lenders and options for borrowers.

The establishment of the GSEs is regarded as the true catalyst of the development of the US secondary market, and it should be no surprise that the GSEs play a very large and active role. Payments to bondholders that hold GSE RMBS are guaranteed by the issuing GSE. As a result, such bondholders are exposed to prepayment risk on the underlying mortgage loans but are not exposed to default risk on the



1 The securitisation sponsor forms the depositor as a special-purpose entity, and contributes mortgage loans to the depositor in exchange for cash.

2 The depositor forms the legal title trust and contributes mortgage loans to the legal title trust in exchange for cash.

3 The legal title trust contributes participation interests in each mortgage loan assigned to it by the depositor or to the applicable subsidiary trust or blocker.

mortgage loans – a feature for which investors must pay a premium. While not formally backed by the US government, this guarantee is often seen by investors as nearly as strong as a US government guarantee; indeed, following the financial crisis both Fannie Mae and Freddie Mac were put under conservatorship by the US government, in part to ensure continued payments on their securities. Because of this guarantee, RMBS issued by GSEs are not subject to US risk retention requirements otherwise mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act adopted in the wake of the global financial crisis.

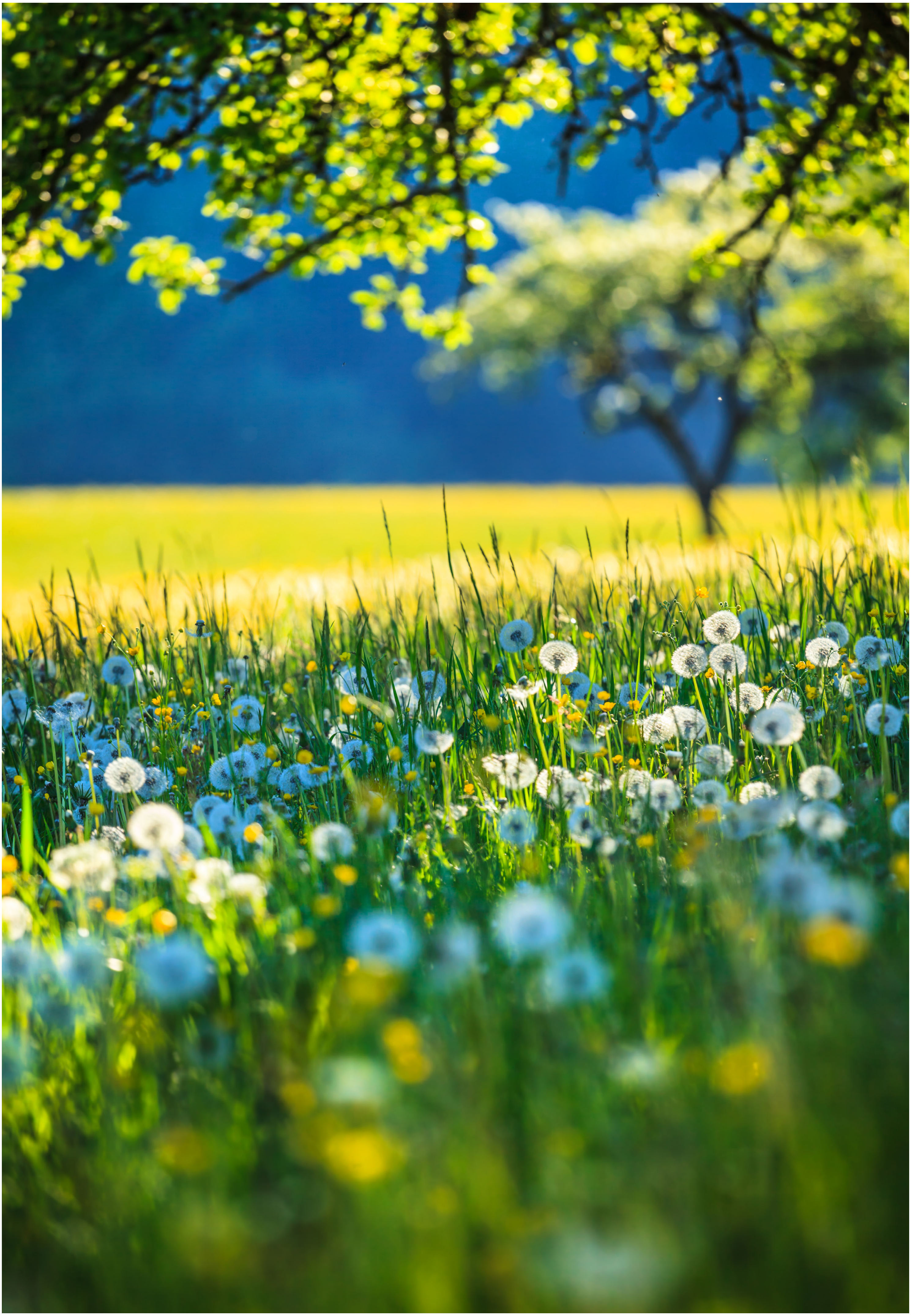
Securitisations sponsored by entities other than the GSEs (known as "private label securitisations") do not have the same guarantee for payment. As a result, the bondholders for private label securitisations are exposed to both a prepayment risk and a default risk on the underlying mortgage loans. To mitigate these risks, private label securitisations use a variety of techniques to provide credit support. Such techniques include overcollateralisation of the mortgage loans backing the bonds, issuing subordinated tranches as part of the RMBS transaction or, in rare instances, the purchase of insurance to guarantee payments on the bonds.

Finally, the structure for US RMBS transactions is heavily driven by tax concerns. In 1986, the US Congress amended the US tax code to create "real estate mortgage investment conduits," better known as REMICs, which are intended to be primary tax vehicles for the securitisation of mortgage loans. REMICs are permitted to hold only mortgage loans and certain other types of related assets and are restricted in their ability to modify or dispose of loans. A REMIC issues two classes of interests: "regular interests" and "residual interests." Regular interests are treated as debt for US tax purposes and can be issued in various classes. There is no entity-level tax on a REMIC; instead, certain income and losses are attributed to the holders of the "residual interests." In creating REMICs, the US Congress incentivised their use by characterising those structures that could be REMICs (for example, a time-tranched securitisation of mortgage loans), but that did not elect to be treated as a REMIC, as "taxable mortgage pools," or TMPs. TMPs are subject to entity-level corporate income tax (a stark contrast to the REMIC structure). Unsurprisingly, issuers are therefore strongly incentivised to use a structure that avoids classification as a TMP.

GSE Reform

In recent years, legislation has been proposed in Congress that would wind down Fannie Mae and Freddie Mac over five years, and replace them with a new housing finance system under which a new federal insurance entity would insure RMBS (but would not purchase mortgage loans), with substantial first loss coverage to be provided by private guarantors who would be able to transfer first loss positions to the capital markets.

While specific legislation has not yet been introduced, the current US Treasury Secretary has made statements indicating the Administration's support of reforming the GSEs, leaving open the subject of comprehensive reform of Fannie Mae and Freddie Mac. It would be difficult to predict what effect such a change could have on either the primary market or secondary market, but this is a subject to watch closely for parties interested in the US mortgage markets.



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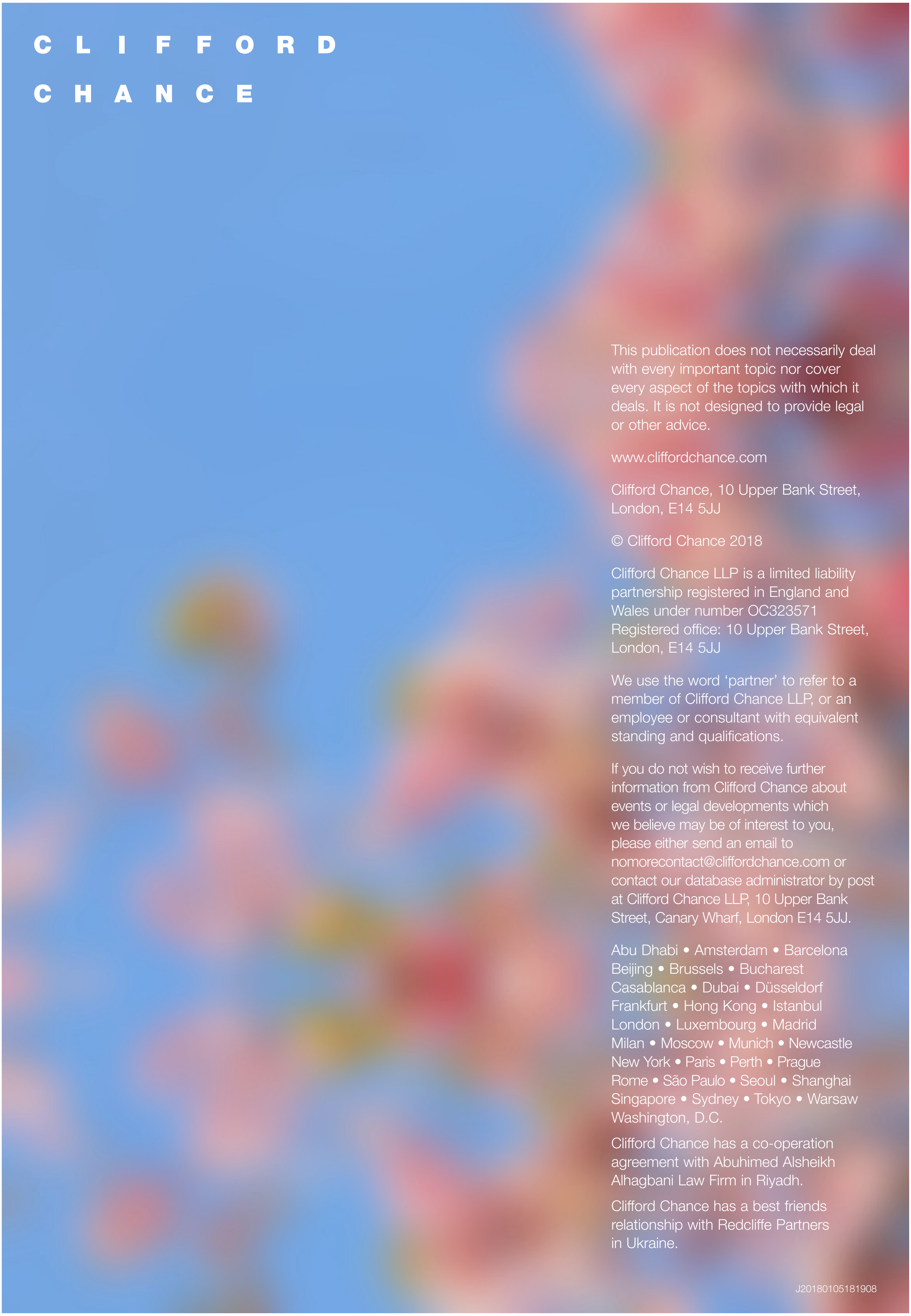

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