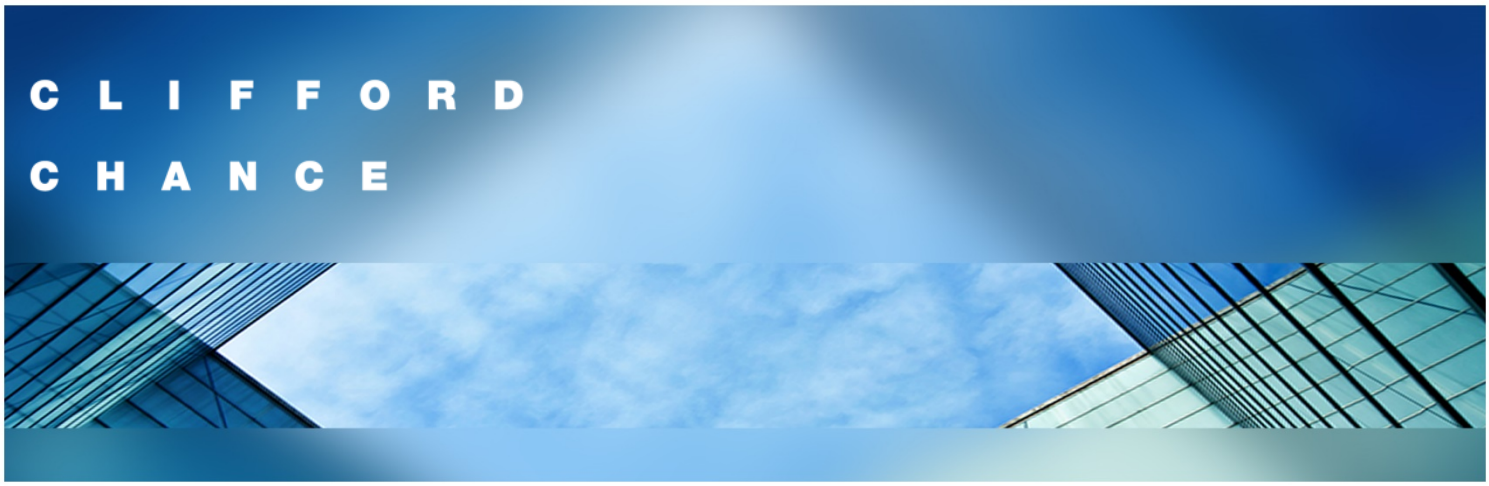


THE EU SECURITISATION REGULATION – CONSIDERATIONS FOR ASIA PACIFIC ISSUERS, ORIGINATORS, SPONSORS AND THEIR ADVISERS

The European Union (EU) Securitisation Regulation (the EU Securitisation Regulation), which replaces previously sectoral securitisation rules and provides a harmonised regime, took effect on 1 January 2019. EU law continues to impose significant (and somewhat increased) compliance obligations on certain EU entities that invest in securitisations. As a result, Asia Pacific managers and originators offering securities to EU institutional investors or structuring securitisations funded by EU institutional investors are likely to be indirectly affected by the EU Securitisation Regulation's requirements.

We have recently published a briefing that provides a detailed overview of this new regime, which is available here, as well as a briefing that discusses application of this new regime in more detail, which is available here. In this briefing, we consider the main elements of the EU Securitisation Regulation relevant to Asia Pacific securitisation transactions, and what compliance under the EU Securitisation Regulation would mean for these transactions.

Key issues

- Harmonised EU securitisation regulation became effective on 1 January 2019 and imposes compliance obligations on additional types of EU institutional investors in securitisations.
- There is a continuing debate on whether EU institutional investors are required to ensure literal compliance by non-EU institutions with the Article 7 transparency requirements.
- Currently, significant portions of the EU Securitisation Regulation (including the risk retention, due diligence and the transparency requirements) fully apply to all branches and affiliates of EU banks and investment firms world-wide, on a consolidated basis.

BACKGROUND AND SCOPE

The EU Securitisation Regulation repeals the main securitisation provisions in sectoral legislation applicable to banks (the Capital Requirements Regulation, or CRR), insurers (Solvency II) and fund managers (the Alternative Investment Fund Managers Directive regime and, collectively, the Old EU Securitisation Framework). It replaces those provisions with a new regime applicable to all institutional investors (which now includes UCITS and pension funds) and originator/sponsor-type entities (whether or not regulated). In addition, it introduces the concept of a "simple, transparent and standardised" (or STS) securitisation, and STS securitisations will receive better regulatory treatment than other securitisations.

For purposes of the EU Securitisation Regulation, a "securitisation" is a transaction involving tranched credit exposure to an asset or pool of assets. A "securitisation position" is an exposure to a securitisation but does not have to be in the form of a security.

Unlike any of the prior securitisation rules that it replaces, the EU Securitisation Regulation provides that originators, sponsors, original lenders and issuers will be subject to severe penalties (including fines of up to 10% of annual net turnover on a consolidated basis) for non-compliance. Furthermore, as a result of concurrent amendments to other provisions of the CRR, these securitisation rules now appear to fully apply to all branches and affiliates of EU banks and investment firms world-wide, on a consolidated basis.

The EU Securitisation Regulation applies to transactions where securitisation positions are created on or after January 1, 2019 and generally does not apply to pre-existing securitisations unless new securities are issued, or new securitisation positions are created on or after January 1, 2019.

CONSIDERING THE SECURITISATION REGULATION IN THE CONTEXT OF NON-EU TRANSACTIONS

When is compliance required?

The jurisdictional scope of the EU Securitisation Regulation is not formally limited and defined. Since it was officially published in December 2017, however, the market appears to have developed a consensus that the jurisdictional application of the EU Securitisation Regulation should be thought about in terms of transaction parties rather than transactions. The EU Securitisation Regulation will need to be considered where any party to a transaction (notably, originator, sponsor, original lender, issuer or investor) is in-scope. A party is in-scope if it is subject to supervision by a national regulator designated under Article 29 of the EU Securitisation Regulation. Because this is a market consensus approach, rather than an approach set out in the text, some uncertainty remains. This is a matter that has been repeatedly raised with regulators by industry representatives and it is hoped that it will be resolved by guidance in one form or another, although it is the view of some regulators that the jurisdictional application is a matter for the primary legislators and not something that can be resolved through a regulatory interpretation.

Expanded definition of EU institutional investors

Article 1(2) of the EU Securitisation Regulation states that the EU Securitisation Regulation applies to institutional investors. The term "institutional investor" is defined in Article 2(12) by reference to entities that are defined in, or fall under, certain EU Regulations that only apply to EU investors. It therefore seems clear that only institutional investors that are established or located in the EU (EU institutional investors) will be required to comply with the EU Securitisation Regulation with respect to their investment activities.

The universe of institutional investors has been significantly expanded by the EU Securitisation Regulation to include new investor classes not previously subject to any securitisation related obligations. The Old EU Securitisation Framework only applied to EU-regulated banks (including investment firms), EU-regulated insurers (including reinsurers) and alternative investment fund managers (AIFMs) either established in the EU or with a full EU passport. Under the EU Securitisation Regulation, three additional investor categories are now also in-scope:

- EU pension funds (and the investment managers who manage their assets);
- UCITS funds (whether self-directed or UCITS management companies); and
- non-EU AIFMs that manage and/or market alternative investment funds in the EU (even when they are only marketing into the EU on a private placement basis using so-called "Article 42 registrations")[1].

[1] Clarification has been sought from ESMA as to whether the definition of "institutional investor" covers any marketing or only marketing based on an AIFMD passport. Until such a clarification is issued, many large non-EU AIFMs are assuming that any marketing, including marketing in reliance on the Article 42 registrations, would be sufficient to bring them into scope.

Direct application of the EU Securitisation Regulation to non-EU originators, sponsors, original lenders or issuers

The EU Securitisation Regulation subjects an originator, sponsor, original lender or issuer involved in a securitisation to a raft of obligations regardless of whether they are regulated entities. In general, these obligations will only apply directly where the relevant entity is established in the EU.

There is no requirement (direct or indirect) on any non-EU originator, sponsor, original lender or issuer to comply with the EU Securitisation Regulation if:

- each of the originator, sponsor, original lender or issuer is established and located outside the EU; and
- no EU institutional investor invests in the exposures created by that securitisation.

When no EU nexus is envisaged for a transaction, transaction participants should include appropriate disclosure and disclaimers in the relevant offering documents to make clear to all investors that their transaction has not been structured to comply with the EU Securitisation Regulation.

The EU Securitisation Regulation requires EU institutional investors to confirm as part of their regulatory due diligence that any securitisation transaction in which they invest complies with relevant requirements. As a result, the EU Securitisation Regulation may apply indirectly to non-EU entities to the extent securitisation positions are offered to EU institutional investors, as discussed further below.

Voluntary compliance by originators, sponsors, original lenders or issuers

If an Asia Pacific based or incorporated originator, sponsor, original lender or issuer plans to sell securitisation exposures to EU institutional investors, these Asia Pacific entities would be indirectly required to comply with the EU Securitisation Regulation, because EU institutional investors are subject to due diligence requirements under Article 5 of the EU Securitisation Regulation. These require EU institutional investors to confirm that any originator, sponsor, original lender or issuer involved in a securitisation has complied with specified provisions of the EU Securitisation Regulation – prior to investing in a securitisation and on an ongoing basis. Accordingly, Asia Pacific originators, sponsors, original lenders and issuers need to consider the impact of the EU Securitisation Regulation when deciding whether to market to EU institutional investors. Historically, some non-EU originators, sponsors and original lenders voluntarily complied with the Old EU Securitisation Framework in order to make their securitisation exposures eligible for purchase by the EU investor base.

Article 5(1) requires institutional investors to verify that:

- originators or original lenders "established in a third country" grant all the credits giving rise to the underlying exposures on the basis of sound and well-defined criteria and clearly established processes as detailed in the EU Securitisation Regulation;
- the originator, sponsor or original lender will retain, on an ongoing basis, a material net economic interest of not less than 5% in the securitisation, determined in accordance with Article 6, and the risk retention is disclosed to institutional investors; and
- the originator, sponsor or issuer has, where applicable, made available the information required by Article 7 in accordance with the frequency and modalities provided for in that Article (discussed further below).

The next issue to consider is the exact scope of the obligations imposed by the EU Securitisation Regulation on non-EU originators, original lenders, sponsors or issuers – this is where there is currently some debate and uncertainty in the market.

Application on a consolidated basis

The amendments to the CRR that accompanied the EU Securitisation Regulation require EU-established credit institutions and investment firms to apply a significant portion of the EU Securitisation Regulation on a consolidated basis. These include the risk retention, transparency and due diligence obligations discussed above, as well as a prohibition on any resecuritisations (i.e. any securitisation of securitisation exposures).

Together, they represent a very significant expansion of a previously manageable rule that mainly affected diligence obligations. Although there appears to be a political agreement to amend this rule in a way that would largely reinstate the *status quo ante*, the problematic version currently applies. Until the amendments are finally adopted and become effective (which is potentially several months away), this rule puts EU banks and investment firms with securitisation operations (including trading activity) in Asia Pacific and other non-EU countries in a difficult position, and entities that are part of an EU banking group will still need to take special care when engaging in securitisation activities, even where there is no other EU nexus to the transaction.

In practical terms, we expect most institutions will choose to engage with their principal prudential regulators and seek comfort that they can rely on the fact that the current version of the rule was never intended (as evidenced by the political agreement to change it) and carry on largely with business as usual. However, there is no assurance that this comfort will be provided.

What does compliance under the EU Securitisation Regulation actually mean for an Asia Pacific transaction?

Risk retention – Article 6

An Asia Pacific originator, sponsor or original lender seeking to market securitisation exposures to EU institutional investors would need to comply with the risk retention obligations set out in Article 6. This Article broadly requires the relevant entity to retain on an ongoing basis 5% risk retention in the transaction. Pursuant to Article 5(1)(d), an EU institutional investor would not be able to invest in any non-EU transaction unless the risk retention obligations set out in Article 6 are complied with and disclosed to the institutional investor (see below).

The risk retention level of 5% and the five retention methods under the Old EU Securitisation Framework remain largely unchanged under the EU Securitisation Regulation, so the 5% risk retention rule under the EU Securitisation Regulation will be familiar to most active Asia Pacific originators and sponsors.

Transparency and disclosure requirements – Article 7

Arguably the most significant change under the EU Securitisation Regulation for the "sell-side" is the introduction of Article 7, which requires EU originators, sponsors and issuers to comply with extensive transparency and disclosure obligations (the Transparency Requirements). It includes the following enhanced reporting requirements:

- *Providing key underlying documentation to investors pre-pricing*: Originators, sponsors and issuers must make available all underlying documentation that is essential for understanding the transaction, including a prospectus (or where there is no prospectus, a transaction summary) prior to a transaction being priced and must designate amongst themselves one entity to fulfil the disclosure requirements (the reporting entity) and who is the primary point of contact in respect of the Transparency Requirements.
- *Asset-level disclosure and investor reports:* Originators, sponsors and issuers must provide asset-level portfolio disclosure and investor reports (in each case using prescribed templates) on an ongoing basis. These templates have yet to be finalised, although on 1 February 2019, the European Securities and Markets Authority (ESMA) published revised draft regulatory technical standards which contain the latest draft reporting templates[2] (Revised RTS). This is the latest development following ESMA's controversial announcement that private securitisation transactions would have to report in substantially the same format (including line-by-line disclosure templates for loan-level data and investor reporting) as public securitisations.
- *Inside information and significant events*: Any inside information relating to the securitisation that the reporting entity is obliged to make public under the Market Abuse Regulation, and significant events for transactions which are subject to the Market Abuse Regulation regime will also need to be reported under Article 7. The Revised RTS attempts to clarify the applicability of the "inside information" and "significant event" templates to reduce market confusion about when each is to be used.

[2] See https://www.esma.europa.eu/sites/default/files/library/esma33-128-600_securitisation_disclosure_technical_standards-esma_opinion.pdf

In addition, public transactions (i.e. where a prospectus is required to be published under the Prospectus Directive) are required to disclose information to a regulated securitisation repository or (where no such repository exists) on a website meeting certain prescribed standards. Private transactions have slightly more leeway, in that there is no prescribed mechanism for disclosure provided that investors, competent authorities and, upon request, potential investors can access information.

As a result of the more prescriptive requirements under Article 7, one of the key interpretive issues for both EU institutional investors seeking to invest in Asia Pacific securitisations, and Asia Pacific originators, sponsors and issuers seeking to market securitisations to EU institutional investors is the extent to which Asia Pacific transactions must comply with the Article 7 disclosure and reporting requirements as a result of the application of Article 5(1) to EU institutional investors. Unfortunately, the application of the Transparency Requirements to EU institutional investors regarding non-EU entities is not settled, and this is discussed further below.

To what extent do the Article 7 disclosure and reporting requirements apply to Asia Pacific transactions?

Article 5(1)(e) of the EU Securitisation Regulation ties together:

- the obligations of EU institutional investors to conduct due diligence under Article 5; and
- the obligations of originators, sponsors and issuers to provide information to investors under Article 7.

The interpretation of this provision is therefore central to any analysis of the applicability of Article 7 to non-EU transactions. The text of Article 5(1)(e) states that institutional investors must verify that "an originator, sponsor or issuer has, where applicable, made available the information required by Article 7 in accordance with the frequency and modalities provided for in that Article." The use of the words "where applicable" in Article 5(1)(e) has been interpreted in different ways by market participants, which has led to divergent views as to whether Article 7 applies to non-EU transactions.

There also appears to be some uncertainty as to what compliance would entail for non-EU transactions, assuming that Article 7 applies. That is, whether a non-EU transaction would:

- have to follow the Article 7 requirements in their entirety, including with respect to the form and content of the reports; or
- be able to comply by providing the information that investors would need to verify pursuant to the due diligence requirements of Article 5, while not complying with the technical requirements of Article 7, such as the form of the reports.

This uncertainty has been made particularly acute by the position of ESMA that both private and public (i.e. EU main exchange listed) transactions need to use prescribed data templates; this issue would be less of a concern if the templates only applied to public transactions. In the absence of guidance and clarification from the regulators, the market has yet to adopt a consensus approach on these issues.

The textual interpretations of Article 5(1)(e)

Some have argued that the use of the words "where applicable" in Article 5(1)(e) can be textually interpreted to mean that Article 7 is not applicable to non-EU originators, sponsors or issuers at all (the first textual interpretation). The basis for this argument is that EU institutional investors:

- need not check that Article 7 disclosure obligations are complied with by non-EU originators, sponsors and issuers, because these entities would technically be outside the jurisdiction of the EU and therefore not subject to the EU Securitisation Regulation itself (subject to the consolidation issue mentioned above); and
- are only required to verify compliance with Article 7 by entities to which Article 7 actually applies (i.e. originators, sponsors or issuers established in the EU) rather than in all cases.

This interpretation effectively excludes Asia Pacific and other non-EU entities from any obligation to comply with the Article 7 due diligence and reporting requirements, even when the transaction is being marketed to EU institutional investors.

The other textual interpretation of the "where applicable" wording in Article 5(1)(e) is that it simply clarifies that an EU institutional investor must determine the type of information that it would need to receive from the originator, sponsor or issuer in order to evidence its compliance with the Article 5 due diligence requirements, because the Article 7 requirements differ between private and public transactions and for specific asset classes. Market participants who favor this interpretation are of the view that non-EU originators, sponsors or original lenders would indirectly be caught by Article 7 as long as there are EU institutional investors in their transactions, because EU institutional investors would ultimately only be able to invest in securitisations that comply with the Article 7 transparency requirements.

Considering the policy impact of the first textual interpretation

Although an argument can certainly be made using the first textual interpretation that EU investors are not required to due diligence non-EU securitisations, this would seem to be at odds with the policy objectives of the diligence obligations and the EU Securitisation Regulation in general.

The underlying policies cited in the recitals to the EU Securitisation Regulation include:

- the need to ensure that EU investors are subject to proportionate due diligence requirements (so that they could properly assess the risks and make an informed assessment on the creditworthiness of a given securitisation instrument);
- enhancing market transparency; and
- revitalising the European securitisation market.

With these policy objectives in mind, it seems unlikely that the regulators and policymakers intended the EU Securitisation Regulation to be interpreted in such a way as to allow an EU investor to undertake less than the required due diligence and obtain less disclosure on non-EU securitisations than would be required for an investment in an EU securitisation of the same type of asset. The first textual interpretation also pre-supposes that the national regulators who have supervisory oversight over EU institutional investors would accept a reduced level of due diligence by EU institutional investors in respect of non-EU securitisations. As we know, EU investors did suffer significant losses on securitisations by non-EU originators during the 2008 global financial crisis.

On the other hand, it is also clear that the fields for data templates were not designed for data from non-EU originators. This points again to the main policy issue being the position of ESMA that the templates must be used for all transactions whether private or public. If private (i.e. not listed on a main EU exchange) transactions did not need to use prescribed templates, the different policy considerations could be reconciled.

Practical approach and next steps

Although clarification has been sought from the authorities, this process will undoubtedly take time. Due to the political nature of the EU Securitisation Regulation, we do not expect that the European Supervisory Authorities (ESMA, the European Banking Authority and the European Insurance and Occupational Pensions Authority, collectively the ESAs) will provide substantial formal guidance without first carefully considering the wider policy implications of doing so. Even if the ESAs or national regulators issue guidance, it would be non-binding in nature as neither the ESAs (individually or collectively) nor the national regulators have the power to suspend the application of the regulation or issue legally binding "no action" letters. It is also unlikely that any person affected would ultimately look for the point to be clarified judicially by the Court of Justice of the European Union.

Market participants should therefore take an informed, pragmatic view when considering which approach to adopt. An investor that is directly impacted by Article 5 should make a considered assessment regarding its overall approach to compliance with the Article 5 requirements with respect to non-EU transactions, in consultation with its internal compliance/legal functions, and where appropriate, external advisors and national regulators, because the investor will ultimately need to be confident that it has complied with its own due diligence requirements prior to investing in any non-EU transactions.

Non-EU originators, original lenders and sponsors will need to balance two opposing considerations when structuring their transactions:

- the ability for EU institutional investors to acquire and hold the securitised exposures (which could be an issue of secondary market transferability, even where the securitised exposures will initially be marketed to investors that are not EU institutional investors); and
- potential operational challenges to demonstrating compliance with Article 7 of the EU Securitisation Regulation.

Regardless of the specific circumstances of a transaction, EU institutional investors will need to have internal policies regarding how they approach compliance to demonstrate that they have considered the issues and adopted a consistent, reasoned approach. This will be helpful in demonstrating good faith and due diligence should regulators seek to challenge whatever approach is eventually taken with respect to diligencing compliance with the Transparency Requirements. Asia Pacific originators, original lenders and sponsors will therefore find that their own approach to the Article 7 transparency requirements may be dictated largely by their investors and potentially made subject to contractual as opposed to regulatory obligations.

Conclusion

The EU Securitisation Regulation has significantly expanded the universe of entities subject to the EU securitisation rules and correspondingly the universe of transactions that will need to conform. Unfortunately, this expansion in scope has been accompanied by uncertainty as a result of the new framework becoming effective well before all necessary secondary regulation were complete and before ambiguous provisions in the EU Securitisation Regulation could be clarified by regulators and policymakers. We remain hopeful that more clarity will develop in the coming months as market participants develop consensus approaches, and regulators and policymakers will finalise key elements of the regime that remain incomplete.

For the time being, market participants (whether on the buy-side or sell-side) should take an informed, pragmatic view and consider the changes introduced by the EU Securitisation Regulation in the context of individual transactions and also on a broader organisational level, and should put in place robust compliance processes for in-scope securitisations and internal written policies which set out a consistent approach to assessing whether compliance is necessary.

AUTHORS

James Pedley
Foreign Legal Consultant
Hong Kong

T +852 2826 2437
E james.pedley
@cliffordchance.com

Andrew Bryan
Knowledge Director
London

T +44 207006 2829
E andrew.bryan
@cliffordchance.com

Kevin Ingram
Partner
London

T +44 207006 2416
E kevin.ingram
@cliffordchance.com

CONTACTS

Francis Edwards
Partner
Hong Kong

T +852 2826 3453
E francis.edwards
@cliffordchance.com

Richard Gordon
Partner
Sydney

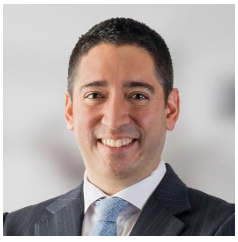
T +61 2 8922 8077
E richard.gordon
@cliffordchance.com

Connie Heng
Partner
Hong Kong

T +852 2826 2457
E connie.heng
@cliffordchance.com

Leng-Fong Lai
Co-Managing Partner
Tokyo

T +81 3 6632 6625
E leng-fong.lai
@cliffordchance.com



Paul Landless
Partner
Singapore

T +65 6410 2235
E paul.landless
@cliffordchance.com

Nicholas Henneberry
Senior Associate
Sydney

T +1 212 878 3452
E nicholas.henneberry
@cliffordchance.com

Kimi Liu
Senior Associate
Beijing

T +86 10 6535 2263
E kimi.liu
@cliffordchance.com

www.cliffordchance.com

Clifford Chance, 27th Floor, Jardine House, One Connaught Place, Hong Kong

Clifford Chance

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Dubai • Düsseldorf • Frankfurt • Hong Kong • Istanbul • London • Luxembourg • Madrid • Milan • Moscow • Munich • Newcastle • New York • Paris • Perth • Prague • Rome • São Paulo • Seoul • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

Clifford Chance has a co-operation agreement with Abuhimed Alsheikh Alhagbani Law Firm in Riyadh.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.