CLIFFORD

CHANCE

TESTING THE NEW FOUNDATIONS

FOREWORD

The last year has seen an extraordinary level of change and turbulence in the securitisation markets. The biggest source of that change and turbulence was not – as many had feared – Brexit. While the political situation in the UK remains hugely changeable – and a disruptive, disorderly no-deal exit remains possible – the story of Brexit so far has been one of impending crisis where the worst outcomes have been averted at the last minute; and markets seem to be becoming inured to the political theatrics as a result.

The main source of change has, in fact, been the new EU Securitisation Regulation – the "New Foundations" we refer to in the title of this year's publication. While the market had hoped to have a complete building by now, we instead have little more than the foundations – the level 1 text; with many details remaining to be filled in and finalised. The result of this has been a significant level of legal uncertainty, with basic questions remaining unclear despite the fact that the new regime has been in place for almost half a year. Examples abound: we know transaction parties are required to disclose loan-by-loan data, but we do not know the specific data required. We know investors are required to check they're getting certain disclosure from EU parties, but it's unclear what they're supposed to check for when investing in non-EU deals. Then there is the awkward, unclear application of the new rules to ABCP and the impracticability of doing a simple, transparent and standardised ABCP programme.

However, it is not all bad. Market participants are coming to grips with the new system, and part of the reason for the delay in the final, detailed rules is that there is genuine engagement by the authorities and a real will to get things right – even if it is taking longer than it ideally would. It is also clear that securitisation regulation is not immune from the political cycle, with European Parliament elections in May exacerbating what were already significant delays. Remarkably, there has been significant issuance in the first half of 2019 despite all the uncertainty. The managed CLO market is back with a vengeance and the pipeline for more traditional consumer ABS issuance is looking healthy as well. People are putting together STS deals even though that framework isn't yet complete, with the need for STS status to achieve LCR eligibility from the end of April next year being a main driver.

In this year's publication we try to distil the lessons learned to date about the Securitisation Regulation regime. We identify areas of remaining uncertainty, some key issues market participants should be thinking about when developing their own approaches, and some solutions that are already beginning to emerge. We hope these reflections prove useful when planning how to go about moving into the market's new architecture. As building works often do, the project is running behind schedule and over budget, but we are still hoping the market has a safe and solid new home when it is finally complete!

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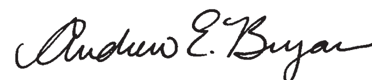

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SECURITISATION REGULATION: FOUNDATIONS LAID, BUT MUCH WORK LEFT TO DO

On 1 January 2019 the EU Securitisation Regulation (the "**Regulation**" or "**Securitisation Regulation**") began to apply. The Regulation is both complex and far-reaching, and contemplates serious consequences for culpable failure to comply. It creates many pitfalls for the unwary because its scope includes transactions that may not be thought of by the parties as "securitisations" and entities that were not previously subject to regulation of securitisation activities. It also has a very wide geographic scope of application because its broadly applicable due diligence rules mean non-EU securitisations will need to consider compliance as well to the extent they wish to market to EU institutional investors.

In this article, we provide an overview of the Regulation, with a focus on the situations where a transaction may be brought into scope, the consequences of being brought into scope and the current status of more detailed rules and guidance that are still forthcoming.

The Securitisation Regulation - which in general applies only to securitisations issued on or after 1 January 2019 - did two main things:

- repealed 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 Managers Directive regime) and recasted those provisions in a new, harmonised securitisation regime applicable to all institutional investors including UCITS and pension funds; and
- introduced a concept of "simple, transparent and standardised" (or "**STS**") securitisation that receives more benign regulatory treatment than other securitisations.

In addition to these two high-level measures, the Securitisation Regulation legislative package introduced a number of other changes, the most significant of which is severe penalties (including fines of up to 10% of annual net turnover on a consolidated basis) for culpable non-compliance applied to originators, sponsors, original lenders and issuers.[1] Another change (that is actually part a package of amendments to the CRR that accompanied the Securitisation Regulation) is an accidental expansion of the scope of EU securitisation rules applicable on a consolidated basis to EU banks, although a fix for this is expected to be published as part of the CRR2 risk reduction package shortly after this publication goes to print.

As a result of the more onerous obligations, the new securitisation regime will likely lead to more focus on ensuring regulatory categorisation is carefully thought through. This theme emerges through a number of the articles further on in this publication, but it is worth rehearsing some of the general principles here to provide context.

Previously, individual compliance obligations were largely on investors, rather than originators, sponsors, original lenders and issuers. This meant that treating a transaction as a securitisation for the benefit of an investor did not add regulatory obligations on sell-side entities. In many cases an originator or sponsor was planning to retain a portion of the deal anyway, so giving risk retention undertakings in such circumstances was a small price to pay for increased demand and liquidity in the transaction. This will no longer be the case under the Securitisation Regulation, as determining that a transaction is a securitisation – or complying on a "just in case" basis in marginal cases – will carry much more onerous obligations imposed directly on sell-side entities. This doesn't mean market participants will have to stop the current practice of occasionally arriving at different (good faith, well-informed, consistent) judgments about the appropriate regulatory treatment for a transaction – it just means those situations now carry a higher cost. Another corollary of the regulation extending fully to sell-side entities is that it is no longer possible for EU originators and sponsors to securitise their assets in "non-compliant" securitisations marketed exclusively to non-EU investors.

1 Investor non-compliance is governed by the prudential regime applicable to the relevant type of investor, e.g. CRR for banks, Solvency II for insurers and AIFMD for alternative investment fund managers.

Is it a securitisation?

For the purposes of the Regulation, the EU definition of a securitisation (see box below) is neither intuitive, nor designed to line up with the definition in the United States.

For US purposes, a securitisation is only present where there is (i) a security; and (ii) that security is backed by a pool of self-liquidating financial assets. While there can be some uncertainty around the details, the US definition has the virtues of being both relatively clear and of lining up pretty closely with the intuitive sense most people in the market would have.

In Europe, by contrast, the focus is around tranched credit exposures. This means it both includes deals that are not covered by the US definition and excludes deals that are covered by the US definition. A pool of underlying assets is still a key feature, but no security is required, and even where you have securities backed by a pool of self-liquidating financial assets (like loans or a leases), the transaction won't be a "securitisation" for regulatory purposes if it is not tranched.

The Securitisation Regulation definition of a "securitisation"

For the purposes of the Regulation, a "securitisation" is a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics:

(a) payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures;

(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;

(c) the transaction or scheme does not create [specialised lending exposures (i.e. object finance) as defined] in Article 147(8) of Regulation (EU) 575/2013.

The details of the EU definition are discussed below, but the key elements to look out for when trying to identify a securitisation are:

- financing of assets that carry credit risk (as opposed to market or other risks) – this means underlying assets will normally be financial assets;
- tranched debt; and
- effective exposure only to the assets financed during the life of the deal.

The technical definition breaks down as follows:

A pool of underlying exposures

The main requirement here is that there should be a pool of underlying exposures on which there is credit risk. For these purposes, the better view is that credit risk means risk of principal losses. So a pool made up of owned real estate, for example, would not meet this requirement (because the risk is market risk on the value of the real estate)[2], but a pool of performing leases over those same properties, or a pool of performing mortgage loans secured on those properties would likely meet the requirement (because the risk is credit risk on the borrowers or lessees).

As a separate note, despite the reference to "an exposure or a pool of underlying exposures", a single exposure in substance is not generally enough to make a securitisation, although this is to do with limb (b) of the definition about distributing losses during the "ongoing life" of the transaction (as to which see below).

Tranching

A transaction is not a securitisation for EU purposes unless it is tranched. As with the other elements of the definition of a "securitisation" the definition of a "tranche" (see box below) is not entirely intuitive. To meet the regulatory definition, tranching must be contractual, it must be done at the transaction level (not investor level) and it must come from an assumption of risk more junior or senior to another tranche.

The Securitisation Regulation definition of a "tranche"

For the purposes of the Regulation, a "tranche" means a contractually established segment of the credit risk associated with an exposure or a pool of exposures, where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in another segment, without taking account of credit protection provided by third parties directly to the holders of positions in the segment or in other segments.

The consequence of this requirement is that many arrangements that may have the appearance of securitisations or that would, economically, produce the effect of tranching are not caught by the regulatory definition. Consequently, single tranche securitisations (common in the US) are not securitisations for EU regulatory purposes. In the EU, these are referred to as "repacks" and are not caught by securitisation rules.

Less obviously, deals generally won't be securitisations for EU purposes where tranching arises either by operation of law rather than contract (e.g. creditors recovering before shareholders), by structural subordination or where the

2 This has particular application in the financing of non-performing loan portofolios – see the article "NPL financing: a securitisation?" later in this section.

transaction is time (and not credit) tranched. These rules need to be considered carefully, however, as regulators have made clear they will not tolerate attempts to game the definition (e.g. using preference shares that operate like debt to avoid "contractual" tranching).

Distribution of losses "during the ongoing life of the transaction or scheme"

This is perhaps the most difficult concept in the EU regulatory definition of a securitisation. What it boils down to, though, is that it has to be possible for junior tranches to suffer losses while senior tranches continue to perform. For this reason, a single-asset "securitisation" will not generally be possible. That single asset either defaults – leading to a default on all tranches of debt – or it doesn't. Tranching may determine the distribution of losses, but it will only do so at a single point of default, not on an ongoing basis.

Another way to think about this is that a securitisation will feature tranches of debt where the probabilities of default, and hence the allocation of losses during the ongoing life of the deal (and not just the loss given default), will be different for each of those tranches.

The specialised lending exception

Finally, even where they meet the criteria laid out above, "specialised lending" arrangements (commonly used in asset/object finance) will not count as securitisations for regulatory purposes.

Specialised lending exposures, broadly, are debt exposures related to a physical asset (typically lending to an entity specifically created to acquire and/or operate that physical asset) where the debt is repaid primarily by the income from operating that asset and the lenders have a substantial degree of control over the asset and the income it generates.

A classic aircraft finance, for example, would often meet these criteria (although see the article "Aircraft finance considerations" further on in this section for further details and worked examples).

Falling into the category of specialised lending is helpful in that it gets you out of the relatively onerous securitisation regime, but it is not an unalloyed good. For credit institutions and investment firms, specialised lending exposures generate capital charges that are often as high or higher than comparable securitisation exposures and have their own regulatory compliance requirements.

Who is in scope?

If a transaction meets the definition of a securitisation, certain parties to that transaction will have obligations under the Securitisation Regulation. Those parties are the originator, sponsor, original lender, issuer (or "**SSPE**" in the jargon of the Regulation) and any institutional investors in the transaction. While "original lender" and "issuer" are relatively straightforward concepts, each of the others needs a bit of explanation. There will also be complex jurisdictional issues surrounding application of the rules to e.g. non-EU branches and subsidiaries of EU entities as well as EU branches and subsidiaries of non-EU entities.

Originator

The originator of an asset is either someone who was directly or indirectly involved in the original creation of the asset (a "**limb (a) originator**") or someone who acquired the asset for its own account and then securitised it (a "**limb (b) originator**"). Because of this rather wide definition, it is entirely possible on any given securitisation transaction that there will be multiple parties who fulfil the definition of an originator. That said, these entities will not normally all be involved in the securitisation. Indeed, some may not even be aware it is happening.

While it is an area of some textual uncertainty, the market seems generally to be interpreting the Regulation to impose obligations only on the originator(s) who are actually involved in the transaction in that role. A good indication of this would be any originator who agrees to take on the risk retention obligation in relation to the transaction, for example.

Sponsor

The definition of sponsor is somewhat more difficult and was originally designed largely for the ABCP market. Broadly, it's an entity that sets up and manages a securitisation but who does not actually securitise its own assets. Historically, an entity has only been capable of being a "sponsor" if it had one of a limited number of EU regulatory permissions. It had been expected that regulatory guidance would be provided in respect of the Securitisation Regulation which would clarify that third country (i.e. non-EU) sponsors were allowed. This, however, appears to have been quietly shelved as too much of a political issue – presumably in the context of Brexit. From a market perspective, that shelving is unfortunate, as the expected regulatory clarification would have facilitated, in particular, risk retention for non-EU CLO managers.

Institutional investor

Wanting to market to "institutional investors" will probably be the most common reason a non-EU securitisation will need to comply with EU securitisation rules. This is because all entities that fit within the definition of an "institutional investor" are subject to due diligence rules under the Securitisation Regulation which require that they check for

compliance with many of the other provisions of the Regulation. The universe of investors subject to such regulatory diligence rules has also been significantly expanded under the Regulation. Historically this has been limited 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 Securitisation Regulation, non-EU AIFMs appear to be covered in respect of any fund marketed into the EU (even on a private placement basis into a single country)[3], as are UCITS funds (including UCITS management companies) and EU pension funds (including their appointed investment managers).

I'm caught by the new rules: what now?

The Securitisation Regulation recasts the main regulatory obligations associated with securitisation. Under the Securitisation Regulation, any originator, sponsor, original lender or issuer involved in a securitisation[4] will be subject to a raft of obligations regardless of their status as regulated entities or otherwise. The obligations recast can be broken down into three main categories: risk retention, transparency and due diligence. We summarise the risk retention and transparency obligations (and break down the differences between the previous EU rules and the new ones) for each of these categories in table format below. The due diligence rules are the subject of a separate article later in this section.

Risk retention

	Old Securitisation Framework[5]	Securitisation Regulation
Nature of retention obligation	Indirect.[6] EU-regulated investors must check compliance. No direct regulatory obligation on retainer to retain, and retention can be avoided where there is no need to make the deal eligible for EU regulated investors.	Direct and indirect. One of originator, sponsor and original lender has a direct regulatory obligation to retain. They must agree who will hold retention, with originator being 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.	Unchanged, except that "sole purpose" originators who exclusively exist to securitise assets are now banned from retaining risk. This formalises the position that already prevailed in the market based on previous regulatory guidance.
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 and this is the intention of the originator.
Retention on a consolidated basis	Only for EU-regulated financial groups.	Unchanged.

3 For more on this point, please see the article "Due diligence: is clarity emerging for institutional investors?" later in this section.

4 In general this will only apply directly where the relevant entity is established in the EU, but compliance with most of these obligations will have to be checked by institutional investors as part of their regulatory due diligence. As a result, non-EU entities will often end up indirectly caught in any case, and arrangers for European-marketed deals may want this to form part of the contractual obligations of non-EU entities.

5 For these purposes, we are referring to the previous risk retention obligations under the CRR, AIFMD/AIFMR and Solvency II.

6 Note, however, that market participants would typically require contractual obligations on relevant sell-side parties in transactions marketed to EU-regulated investors.

Unfinished business
Risk retention is an area where regulatory technical standards ("**RTS**") are mandated, and the European Banking Authority did indeed produce final draft standards in a report dated 31 July 2018.[7] These draft standards are still in the Commission's inbox almost a year later, leading to some market concern that certain aspects of them had been objected to, even though no formal rejection or request by the Commission for changes has been made.

The consequences of this are twofold:

- The transitional provisions of the Securitisation Regulation specify that the existing RTS made under CRR should be followed until such time as the new RTS apply. The trouble with this is that risk retention structures are meant to be put in place once, for the life of the transaction, and it is not clear that transactions put in place during the interim period from 1 January until the new RTS applies will be grandfathered. Therefore, to the extent the new rules are more restrictive, it's possible transactions would need to be unwound following the adoption of the new standards.
- This, in turn, leads to broader uncertainty because a number of important market participants will have a low tolerance for the risk that their transaction may not be risk retention compliant once the new rules are made. There are also entirely novel issues (such as the specifics of the adverse selection test and the definition of a "sole purpose originator") that were not addressed in the existing RTS made under the CRR.

Practical approach
In practical terms, there are two helpful factors to bear in mind:

- There is precedent for the current situation. The CRR (which changed the retention rules) began to apply on 1 January 2014, but the RTS made to specify the detailed rules were not applicable for several months after that. As a result, for the first several months of 2014, transactions proceeded on the basis of the level 1 text alone, which was sufficiently clear for plain vanilla transactions (e.g. standalone public securitisations of prime residential mortgages with a single originator). Now, as then, more complex arrangements may have to wait for the RTS to be finalised, but these kinds of plain vanilla arrangements will normally have sufficient information to comply based on the level 1 text alone.
- The final draft RTS published by the EBA in July 2018 preserves in very large part the substance of the RTS made under the CRR. Accordingly, it seems quite likely that the rules around e.g. how to retain when there are multiple originators, will stay the same. This is an improvement on the situation in the early part of 2014 when it was clear that quite a lot of the rules were likely to change but there was very little clarity about what form that change would take. In addition, where there are "new" rules such as the ban on sole purpose originators retaining, these are mainly just codifications of existing informal guidance and market practice, so the functional outcomes are not likely to change significantly from current practices.

Accordingly, although risk retention is complex and important to get right, the market has so far been able to have reasonable confidence for most relatively straightforward transactions even before the risk retention RTS are finalised. More complex and innovative structures continue to be more difficult, with anecdotal evidence of some transactions appearing to be held back from issuing until the rules are fully clarified.

7 https://eba.europa.eu/documents/10180/2298183/Draft+RTS+on+risk+retention+%28EBA-RTS-2018-01%29.pdf

Transparency

	Old Securitisation Framework[8]	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.	Securitisation Regulation. Prospectus Directive (or Prospectus Regulation, from 21 July 2019), 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 are 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, although third-country entities will generally be out of scope. EU-regulated investors required to diligence information that broadly mirrors what originator, sponsor and SSPE are required to disclose. Significant controversy remains over what disclosure EU-regulated investors are required to ensure they obtain where the originator, sponsor and issuer/SSPE are all third-country entities outside the scope of EU disclosure obligations.[9] Detailed disclosure required in all cases, regardless of whether the transaction is public or private. Securitisation Regulation disclosure obligations sufficiently detailed and onerous as to make others (bar the prospectus obligations) 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. See next row.
Mechanism for disclosure	Depends heavily on factors listed above. Potential to restrict disclosure of information to private/ specifically negotiated means where so desired.	Public transactions (i.e. where a prospectus is required to be published under the Prospectus Directive) must disclose to a regulated securitisation repository or (where none exists) on a website meeting certain prescribed standards.

8 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 were formally in force and applied for two years, they were never capable of being complied with so they were not de *facto* applicable.

9 Note the location of the exposures/assets is not relevant to this analysis.

	Old Securitisation Framework[8]	Securitisation Regulation
		Private transactions do not have a prescribed mechanism for disclosure provided investors, competent authorities and, upon request, potential investors can access information. Certain national competent authorities ("**NCAs**") may prescribe the method, frequency and content of information to be reported to them on private transactions.[10] Parties will need to check the approaches of the relevant NCA(s).
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 documentation essential for the understanding of the transaction, including prospectus or (where there is no prospectus) a deal summary, loan level data on a prescribed template, investor reports on a prescribed template, reports of any significant events/material changes on a prescribed template. Additional items such as the STS notification (in prescribed format), a liability cash flow model and (where applicable and available) 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, in each case before pricing. Loan level data and investor reports quarterly (or monthly for ABCP). Significant events/ material changes to be reported without delay and in line with regular reporting.

Unfinished business

Disclosure is perhaps the area worst affected by the lack of finalised technical standards and guidelines. In particular, the requirements to provide loan-level data, investor reporting and event-driven reporting all require further specification to be capable of full compliance.

ESMA released its final draft RTS around the content of the reporting obligations and annexed draft disclosure templates on 22 August 2018.[11] This final report was the subject of a great deal of controversy, not least because it departed very significantly from the approach previously consulted upon and introduced, for the first time, the idea that private transactions would have to report using the detailed disclosure templates – this despite a consultation that explicitly scoped private transactions out of the obligation to report on legislatively prescribed templates. This change was (and continues to be) viewed as exceptionally problematic in many areas – especially sections of the market that

10 See, for example, the direction from the UK's Prudential Regulation Authority and Financial Conduct Authority in this respect: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/securitisation-regulation-pra-and-fca-joint-statement-on-reporting-of-private-securitisations

11 https://www.esma.europa.eu/sites/default/files/library/esma33-128-474_final_report_securitisation_disclosure_technical_standards.pdf

have historically thought of themselves as private, including ABCP transactions, synthetics, cash CLOs and a number of loan-on-loan financings. In each of these cases, market participants (quite reasonably) did not fully engage with the consultation exercise of coming up with disclosure templates because they did not expect to have to report on those templates. When ESMA made clear in its final report that even private deals would need to report using templates, they did not then reopen the consultation to get input from market participants who – again, perfectly legitimately – had not previously provided comment because they had relied on ESMA's assurances that they would be out of scope.

Since then, and at the Commission's direction, ESMA published a revised version of its final draft technical standards[12] on 31 January 2019. It has also published a Q&A document to further clarify how to comply with the Securitisation Regulation disclosure requirements.[13] Between the 31 January revisions and the Q&A document, substantial progress has been made:

- The number of reporting fields in respect of which a "no data" response is permitted has been significantly expanded, giving market participants comfort that they will be able to avoid a "cliff-edge" when the new reporting requirements begin to apply in full. This should be tempered, however, by ESMA's attitude to "no data" responses, which clearly is wary of market participants seeking to avoid disclosure. They remind frequently in the RTS and Q&A that the "no data" responses are "meant to signal legitimate cases of information not being available and under no circumstance should constitute an exemption from reporting requirements" and that "use of these options…is expected to be limited and, where present, to converge quickly towards reporting the relevant information". It should be expected, then, that heavy use of "no data" fields will be carefully scrutinised by regulators.
- The Q&A has settled a question raised in some corners of the market about the liability consequences of designating a reporting entity as parties are required to do. As widely expected, ESMA has confirmed that this designation does not relieve other parties of their liability. So, for example, designating the issuer/SSPE as reporting entity would not relieve the originator or sponsor of a transaction from liability if that reporting is not done properly.
- A number of transitional issues have been clarified. Most importantly, ESMA seems clear that no grandfathering from the Securitisation Regulation templates will be available for transactions issued since 1 January 2019. They will be required to report on the new templates from their date of application – although when that date will be remains unclear. Whether other forms of comfort or transitional relief (e.g. another statement similar to the one issued by the ESAs on 30 November 2018 described overleaf)[14] will be made available for these transactions is also unknown.
- Further, no securitisation repositories have yet been authorised at the time this publication went to print, and some had wondered whether transactions reporting to other websites (as permitted until a repository is authorised) would be "grandfathered" out of having to report to a repository for the life of the transaction. It seems this will not be the case. Neither will such transactions be required to "re-report" data, but ESMA does strongly encourage making all transaction data available in one place, even if it is in different formats.
- There had been some controversy over whether non-ABCP transactions that have traditionally reported monthly (such as credit card master trusts) would be required to produce quarterly summaries due to the textual specification for quarterly reporting. ESMA has confirmed that reporting more frequently than required is permissible and, in doing so, have specifically highlighted monthly reporting for non-ABCP securitisations as permissible.
- There has been extensive debate about event-driven reporting – that is, the reporting of "inside information" and "significant event" information. While the approach is still somewhat unclear, it would appear that ESMA proposes to functionally collapse these into one standard of reporting and to require that public transactions (that is, transactions subject to a prospectus obligation under the Prospectus Directive) report on a template they have set out. Private transactions would not be subject to the template but would nonetheless be subject to a similar standard of reporting. As to timing, the relevant information would need to be reported "without delay" but – apparently – also regularly

12 https://www.esma.europa.eu/sites/default/files/library/esma33-128-600_securitisation_disclosure_technical_standards-esma_opinion.pdf

13 The latest version is dated 27 May 2019 and is available here: https://www.esma.europa.eu/sites/default/files/library/esma33-128-563_questions_and_answers_on_securitisation.pdf

14 https://esas-joint-committee.europa.eu/Publications/Statements/JC_Statement_Securitisation_CRA3_templates_plus_CRR2_final.pdf

together with quarterly (or monthly, in the case of ABCP) reporting. Significantly, ESMA still appear to consider the very fact of doing regular reporting a "significant event" that would trigger the requirement to report on their template for a public transaction at least.

- There are a number of important technical clarifications offered about general issues like the use of proxy data (not allowed), the acceptability of rounding numerical figures (not generally acceptable) and how to report master trusts, transactions funded by multiple ABCP programmes, further advances on existing loans, as well as the meaning of, and appropriate approach to reporting, a large number of fields where specific questions have been asked.

In addition, the European Supervisory Authorities (that is, EBA and ESMA, together with the European Insurance and Occupational Pensions Authority, collectively the "**ESAs**")) published a joint statement[15] on 30 November 2018 aiming to smooth the transitional problems by encouraging NCAs to take a proportionate and risk-based approach to enforcement of the disclosure obligations until the Securitisation Regulation rules in this respect were finalised. While this is helpful, it leaves a number of issues outstanding – not least because neither the ESAs (individually or collectively) nor the NCAs have power to formally suspend application of legislation or issue US-style "no action" letters, even in situations where it is self-evidently impossible or impractical to comply. After some initial hesitation, however, market participants appear to have been able to take pragmatic approaches to this on both the sell and buy sides.

Moreover – and quite apart from the ongoing difficulties with the technical standards needed – a number of elements of the level 1 text remain uncertain. A significant aspect of this is the confusing application of the disclosure requirements with respect to ABCP (as to which see the article "Considerations for ABCP conduits" later in this section). More generally, it is not clear how far the exemption from disclosure obligations for confidentiality extends. In theory, parties may adjust disclosure of information on the basis it is subject to an obligation of confidentiality. The rules around confidentiality make it possible for parties to comply by anonymising or aggregating data in some cases and summarising documents in others, but there is a difficult tension left unresolved in the Regulation's text between the requirement to provide information under the Regulation on the one hand and the need to protect legitimate commercial and other confidentiality on the other. It would obviously be an abuse, for example, to include a confidentiality clause in all deal documents and, on that basis, refuse to make them available. On the other hand, some contractual confidentiality obligations are evidently meant to be effective to protect from disclosure under the Regulation's disclosure regime or there would not be a reference to complying with "any confidentiality obligation relating to customer, original lender or debtor information".

A classic example of this tension would be non-granular securitisations (common among CMBS transactions) where the individual loan documents would arguably be essential to the understanding of the transaction (and therefore required to be disclosed) but also often commercially sensitive and possibly covered by confidentiality provisions (and therefore permitted to be summarised instead of disclosed).

Practical approach

The result of all of the above is that market participants have been taking (since 1 January) and – in general – continue to take a pragmatic view in order to be able to issue. In practical terms:

- Many aspects of Article 7 (containing the disclosure requirements) of the Securitisation Regulation do not require further clarification by technical standards. These need to be complied with on all in-scope securitisations immediately. That is to say it is necessary to disclose transaction documents, a transaction summary (where there is no prospectus) and the STS notification (where relevant). The lack of templates does not provide an excuse to delay compliance with these obligations.
- Market participants executing public deals will need to keep an eye on the ESMA website to see whether any securitisation repositories have been authorised. This is expected within the coming months. To the extent there are none, parties will need to report to an appropriate website. It may be sensible to work with one of the organisations known to be applying for authorisation as a securitisation repository in order to facilitate the transition from that website to an authorised repository more smoothly once authorisation is obtained, but the latest version of the ESMA Q&A makes clear that migration

15 https://esas-joint-committee.europa.eu/Publications/Statements/JC_Statement_Securitisation_CRA3_templates_plus_CRR2_final.pdf

of old information to a repository – while desirable – will not be required.

- Market participants doing private deals will need to keep in touch with their NCAs to make sure they understand and can comply with any local reporting requirements for private deals that may apply.
- Where there is a CRA3 template relevant for the transaction, practical efforts should be made to report according to those templates, particularly on public deals. To the extent there are gaps, it will be helpful if parties can point to a historical market practice that is being followed and/or a gap analysis together with a critical assessment of the costs of filling those gaps against the transparency gains from doing so. If much of the information required for the CRA3 template is currently being provided in other formats (particularly on private deals) then it is likely such information can continue to be supplied in the same manner.
- Where there is no CRA3 template relevant for the transaction[16], it may be useful to consider the ESMA templates that were issued in draft on 31 January 2019 and make an effort to comply with those to the extent practicable. Strict compliance with these draft templates is, of course, not necessary but this will likely ease the process of eventual transition since the current expectation is that those templates will not change significantly. Again – to the extent historical market practice and/or a cost-benefit analysis can be pointed to, that will be helpful in demonstrating interim compliance with Article 7.
- On confidentiality, transaction parties will need to take a sensible, good faith approach. History will be a good guide as to what information can legitimately be protected as "confidential" (e.g. originator names on ABCP transactions), but equally it will be important to comply with the spirit of the Regulation, which is clearly to have investors rely less on offering documents and summary data provided by originators, sponsors and issuers in favour of making more granular and primary sources available to them. On non-granular securitisations, the solution may be to provide a "summary" of the document that is simply a redacted version that does not include confidential information such as account numbers, signatures and margins. In the CMBS market, it is apparent that some participants are taking the position that an extensive description of the underlying loan documents in the offering materials is sufficient, without the need to disclose the full contracts. Where it is not possible to anonymise or summarise confidential information (as will often be the case for CLOs), the solution may be to remove a problem loan from the deal.
- Regardless of the specific circumstances of a transaction, it will be key for institutions to have an internal policy about how they approach compliance in order to be able 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. This is especially true for ABCP and confidentiality issues where the level 1 text is difficult to interpret and apply.
- Originators and sponsors on private deals will also need to consider their approach to the concept of a "potential investor". Any potential investor is entitled to the information set out in Article 7, but no definition is provided of this term. In general, this has historically been (and we expect it will continue to be) an area where market participants take a case-by-case approach as to who is a *bona fide* potential investor. On a public deal, that might be anyone qualified to invest, but on a private deal with transfer restrictions, that universe may be limited to people the originator is happy to have invest in the transaction, for example.
- On the investor side, it will be necessary to diligence compliance with the disclosure obligations. A similarly pragmatic approach will need to be taken by investors, bearing in mind the ESAs' statement of 30 November, in order to satisfy this obligation. Investors will also need to carefully consider their view of the obligation on them to check compliance with disclosure obligations in respect of non-EU issuers, originators and sponsors. While there are some textual arguments to support the idea that investors need not check for EU-style disclosure in such cases, we continue to believe that there are textual arguments pointing the opposite way and it would be a brave investor who took that position without firm regulatory blessing. As regulators are aware of the issue and will likely consider offering clarification in due course, ultimately this is more of a policy issue than a matter of strict legal analysis.
- The final element where a pragmatic approach will be needed will be around

16 CRA3 templates exist for residential mortgages, commercial mortgages, loans to SMEs, auto loans, consumer loans, credit card loans, and leases to individuals and/or businesses.

the distinction between private and public transactions. While that line is formally drawn around the need to publish a prospectus under the Prospectus Directive (soon to be Prospectus Regulation), the market is in some cases preparing to undertake reporting to a securitisation repository on a voluntary basis more widely – that is, even where it is not strictly required by the definition of a public transaction. In particular, this is happening on some underwritten, widely offered transactions that would historically be thought of as "public" deals but are listed on a market which is not a regulated market (e.g. the Global Exchange Market of the Irish Stock Exchange or the Euro MTF of the Luxembourg Stock Exchange). This approach arises from a concern that if these deals fail to report to a securitisation repository it may create a sense in the official community that the market is seeking to avoid providing the data transparency sought by policymakers on a technicality – with the result that the legally-mandated review of the situation[17] could well lead to further onerous reporting obligations being imposed on what are in substance private transactions in the future.

Other level 1 issues

In addition to recasting the risk retention, transparency and due diligence obligations, there are a number of other items in the Securitisation Regulation legislative package that are worthy of note, some of which also have some unfinished business.

Jurisdictional scope

Unfortunately, the jurisdictional scope of the Regulation is nowhere formally limited or defined. Over the time the Regulation has been in the Official Journal, however, the market has developed what appears to be a consensus approach to some of these issues. That is, jurisdictional scope should be thought about in terms of transaction parties rather than transactions. The Regulation will need to be considered where any party to it (notably, originator, sponsor, original lender, issuer or investors) is in-scope. In turn, the Regulation's reach is limited to parties who are subject to supervision by an NCA designated under Article 29 of the Regulation.

Because this is a market consensus approach, rather than an approach set out in the text, a certain amount of compliance uncertainty remains. In particular there is uncertainty around the ability to have non-EU sponsors, around the diligence obligation applying to non-EU AIFMs marketing funds on a private placement basis in the EU and around the need for EU-regulated investors to check disclosure by non-EU issuers, sponsors and originators. These are all matters that have been repeatedly raised with regulators by industry representatives and it is hoped that it will be resolved by guidance issued by regulators in one form or another.

Problems for acquired portfolios

The 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. For more detail on this, see the article "Portfolio acquisitions and Article 9" later in this section.

STS

STS is, somewhat counterintuitively, one of the areas that is most advanced as it is a bit of an "optional extra" rather than core regulation. While there will undoubtedly be difficulties with compliance, these stem largely from the basic requirements of the Regulation (compliance with the Article 7 transparency obligations, for example, is required for STS status – so uncertainty there also affects STS). The EBA has largely finalised its guidelines on interpretation of the STS criteria, the Commission has adopted the technical standards on STS notification and also on what constitutes homogeneity. These are all, by and large, extremely sensible and helpful. While the homogeneity RTS are still subject to a possible objection from the Parliament or Council, this seems unlikely, and the market appears relatively happy to proceed on the basis of the technical standards and guidelines as they currently stand.

Impact on documentation

The markets have been considering what changes will be necessary to documentation to reflect the new regulatory framework. Updating legislative references is a necessary but relatively straightforward aspect of this. Slightly less straightforward have been the new risk factors and descriptions of the regulatory framework that need to go into disclosure documents. These too, however, are already beginning to show signs of standardisation. On the slightly less standard end of the spectrum is the approach to disclosure

17 Article 46 of the Regulation mandates a review of the use of the private transaction exemption from reporting to securitisation repositories. Article 46(d) specifically requires the Commission to express a view about whether full, public-style reporting obligations should be extended to private transactions.

on STS transactions, where there are significant differences across jurisdictions around how much of the STS information is put in the STS notification versus the offering document, for example.

On the more difficult end of things is the approach to realignments necessary in transaction documentation to allocate the risk of liability that arises from the new regulatory framework (including the risk of losing STS status, where relevant). On this, there is no market consensus, and much still appears to depend on the particular facts and circumstances of the transaction, including the relative bargaining power of the parties. Issues such as the possibility of an issuer fine for failure to comply with disclosure rules (and the associated possibility of indemnities being required of the originator and/or sponsor) are difficult and sensitive issues that are still being approached case by case.

Conclusion

The application on 1 January 2019 of the Securitisation Regulation was always going to cause some disruption – any major change to a regulatory framework always will. Unfortunately, the disruption actually caused is much greater than was necessary or intended because the framework began to apply well before it was completed with secondary legislation. Making matters worse, it was always set up to apply in a "big bang" way, as opposed to taking a staged approach so that, e.g. securitisation repositories and third party verifiers of STS status could be authorised and ready to go by the time the rest of the market had need of their services.

Much progress has been made since 1 January, and there is serious and continuing engagement from regulators, which is encouraging. The damaging uncertainty that results from the unfinished business is slowly diminishing as a result, though at a slower rate than might have been hoped for by all sides, including the regulators.

Nonetheless, the market has so far found a way to continue operating in the interim – with CLOs and CMBS showing especially strong performances by historical standards and more traditional asset classes having a very full pipeline. We are optimistic that the outstanding issues will be resolved rapidly so that certainty and predictability support the return of the healthy, vibrant and safe securitisation markets intended to be promoted by the Regulation in the first place.

SECURITISATION REGULATION: CONSIDERATIONS FOR US MARKET PARTICIPANTS

Unlike the US securitisation rules, EU law imposes significant compliance obligations on certain EU-regulated entities that invest in securitisations. As a result, US securitisers offering asset-backed securities to EU institutional investors may be indirectly affected by the Securitisation Regulation's requirements.

In this article, we consider the main elements of the Securitisation Regulation relevant to US market participants (namely US issuers, originators and sponsors), and what compliance under the Securitisation Regulation would mean for their transactions.

When is compliance required?

As mentioned in the previous article, the jurisdictional scope of the Securitisation Regulation is not formally limited and defined. The consensus approach in the market is that application of the Securitisation Regulation should be thought about in terms of transaction parties rather than transactions (or assets). The Securitisation Regulation will need to be considered where any party to a transaction (notably, originator, sponsor, original lender, issuer or investor) is in scope by virtue of having a competent authority designated under Article 29 of the Securitisation Regulation.

Expanded definition of EU 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 where there is a nexus with EU investors.

That said, and as further discussed in the article "Due diligence: is clarity emerging for institutional investors?" further on in this section, the universe of institutional investors has been significantly expanded by the Securitisation Regulation to include new investor classes not previously subject to any securitisation-related obligations. The old 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 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].

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

The 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 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 Securitisation Regulation.

Voluntary compliance by originators, sponsors, original lenders or issuers

If, on the other hand, a US originator, sponsor, original lender or issuer plans to sell securitisation exposures to EU

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

institutional investors, these US entities would be indirectly required to comply with the Securitisation Regulation, because EU institutional investors are subject to due diligence requirements under Article 5 of the 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 Securitisation Regulation – prior to investing in a securitisation and on an ongoing basis. Accordingly, US originators, sponsors, original lenders and issuers need to consider the impact of the 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 securitisation framework in order to make their securitisation exposures eligible for purchase by the EU investor base.

The specific substantive diligence obligations imposed on EU institutional investors are discussed in more detail in the next article, but by way of summary, Article 5(1) of the Securitisation Regulation 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 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 Securitisation Regulation on non-EU originators, original lenders, sponsors or issuers – this is where there is currently some debate and uncertainty in the market.

What does compliance under the Securitisation Regulation actually mean for a US transaction?

Risk retention – Article 6

A US 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 regime remain largely unchanged under the Securitisation Regulation, so the 5% risk retention rule under the Securitisation Regulation will be familiar to most active US originators and sponsors.

Transparency and disclosure requirements – Article 7

Arguably the most significant change under the 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**"). These are discussed in detail in the previous article.

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 US securitisations, and US originators, sponsors and issuers seeking to market securitisations to EU institutional investors is the extent to which US 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 the subject of differing opinions.

Article 5(1)(e) of the 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* [emphasis added], 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 broad, general due diligence requirements of Article 5 (excluding 5(1)(e)), 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. listed on an EEA regulated market or offered to the public on a non-exempt basis) transactions need to use prescribed data templates; the 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. Ultimately, however, this is a policy issue for regulators and policymakers rather than a point likely to be resolved in a court of law. It is, after all, extremely unlikely the point will ever be litigated, much less appealed all the way to the Court of Justice of the European Union.

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 Securitisation Regulation itself; and
- the meaning of the words "where applicable" quoted above is that investors are only required to verify compliance with Article 7 by entities to whom Article 7 is applicable (i.e. originators, sponsors or issuers established in the EU) rather than in all cases.

This interpretation would effectively exclude US and other non-EU entities from needing to comply with the Article 7 disclosure requirements, even when the transaction is being marketed to EU institutional investors (and, indeed, even when the assets being securitised are located in the EU).

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 depending on the specific nature of the transaction (e.g. between private and public transactions and for specific asset classes). Market participants who favour 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 Securitisation Regulation in general.

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

- the need to ensure that EU investors are subject to proportionate due diligence requirements (so that they can 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 Securitisation Regulation to be interpreted in such a way as to allow an EU investor to undertake less due diligence and obtain less disclosure on non-EU securitisations (including non-EU securitisations of EU assets) than would be required for an investment in an equivalent EU securitisation. 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 suffered 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 assets. This points again to the main policy issue being the prevailing regulatory position that the templates must be used for all transactions whether private or public. If private (i.e. not listed on an EEA regulated market and offered only on an exempt basis) transactions did not need to use prescribed templates, the different policy considerations could be reconciled far more easily.

Practical approach and next steps

In substance, this is a policy matter rather than a legal point. Although clarification has been sought from the authorities, this process will undoubtedly take time. Due to the political nature of the Securitisation Regulation, we do not expect that the European Supervisory Authorities (the "**ESAs**") will provide substantial formal guidance without first carefully considering the wider policy and political 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 US-style "no action" letters. As mentioned above, 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. Thus far there has been significant variation in approaches. A number of transactions are being marketed on the basis they do not comply with the Securitisation Regulation and do not need to. We are also aware that EU institutional investors are, in turn, split on their approach. Some are investing on the basis of the first textual interpretation described above, but many continue to resist (and refuse to invest) on the basis they are not willing to accept the risk that that interpretation is ultimately rejected by the authorities.

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. It should do so in consultation with its internal compliance/legal functions, and where appropriate, external advisers 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 liquidity, 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 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. US 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 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 regulations were complete and before ambiguous provisions in the Securitisation Regulation could be clarified by regulators and policymakers. We remain hopeful that more clarity will develop in the coming months as market participants continue to move towards consensus approaches, and regulators and policymakers take steps to finalise key elements of the regime that remain incomplete.

For the time being, market participants (whether on the buy side or sell side) should continue to take an informed, pragmatic view and consider the changes introduced by the 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.

SECURITISATION REGULATION: DUE DILIGENCE: IS CLARITY EMERGING FOR INSTITUTIONAL INVESTORS?

Since first proposed in 2015, largely in response to the global financial crisis, the revised and expanded due diligence requirements of the Securitisation Regulation have generated much debate, but what are they, who is affected and what have been the issues for those in the market trying to implement them? These are some of the questions we have received over the past few years as institutional investors have contemplated if and how they are affected. In this article, we outline some of the most common issues for asset managers and other institutional investors seeking to implement the new requirements.

What are the due diligence requirements?

The due diligence requirements in the Securitisation Regulation, which are summarised in the box overleaf, repeal and replace many of the securitisation provisions in the sectoral legislation for alternative investment funds (AIFMD), insurers (Solvency II) and banks (CRR) introducing a harmonised set of requirements for different types of institutional investors within the EU securitisation framework.

As well as harmonising and modifying the existing requirements, the due diligence that must be carried out by institutional investors prior to and while holding a securitisation position have been expanded. The main new features involve understanding other parties' obligations with regard to disclosure and the "simple, transparent and standardised" (STS) designation. This is because, in addition to understanding the securitisation that is to be invested in, institutional investors are now required to check that the disclosure obligations have been complied with and that (where applicable) the STS designation has been appropriately claimed by the relevant sell-side entities. Adherence to the risk retention rules is also required, as was the case under the previous sectoral regimes.

STS notifications

Institutional investors can rely on the STS notification and on the information disclosed by the originator, sponsor and SSPE "to an appropriate extent" and not "solely or mechanistically". In practice, this probably means that an investor may place some reliance on the disclosure including any offering document or STS notification, although it does not remove the need for the institutional investor making their own critical assessment and, where warranted, undertaking their own due diligence.

Who is in scope?

There has been a significant expansion in the types of institutional investors subject to the due diligence requirements, as along with alternative investment fund managers ("**AIFMs**"), insurers and banks, who have had to comply with the applicable requirements in their respective sectoral legislation, UCITS (both UCITS management companies and self-managed UCITS) and EU pension funds are now in scope for the first time.

The question of whether non-EU AIFMs are in scope has caused significant debate, as this would greatly extend the territorial reach of the legislation. The issue arises from the broad definition of "institutional investor" which includes an AIFM "that manages and/or markets alternative investment funds in the Union". Based on this wording, it appears that non-EU AIFMs that register for marketing under the AIFMD national private placement rules would fall within the definition of institutional investors, even if registration were only in one EU member state. This would be in line with the policy objectives behind the Securitisation Regulation and aligns with other recent EU legislation, SFTR for example, which are increasingly extra-territorial in scope and do apply to non-EU AIFMs. Clarification has been sought from the European Supervisory Authorities, but the weight of market practice appears to be to treat non-EU AIFMs as caught even where their only EU nexus is registration under national private placement rules. Until any official clarification is issued, many large AIFMs will continue taking the cautious approach that any marketing, including marketing under AIFMD national private placement rules, would be sufficient to bring them into scope.

What issues arise from implementation?

Timing and grandfathering: Broadly speaking, the Securitisation Regulation

Securitisation Regulation due diligence in a nutshell	
What type of institutional investors are in scope	As with current framework, plus pension funds, internally managed UCITS and UCITS management companies. Non-EU AIFMs marketing in the EU on the basis of AIFMD national private placement regimes may now also be covered.
Specific items to be diligenced	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.
Verification of compliance with direct disclosure obligations	Institutional investors are required to check that all information required to be disclosed has been disclosed, even where not otherwise relevant for diligence procedures. They are also required to diligence the STS notification (where it exists) even where STS status is not relevant to their investment decision.
Right to delegate diligence obligations	Institutional investors can delegate the obligation to carry out regulatory diligence to a third party. Applies only where that third party is itself an institutional investor and makes investment decisions on behalf of the principal.
Secondary legislation to clarify diligence obligations	No secondary legislation provided for. Institutional investors will need to speak to their regulators and consider their own approaches. This has presented a number of challenges for institutional investors, especially with respect to proportionality issues.

applies to new securitisations which are issued on or after 1 January 2019 or legacy securitisations the liability side of which is significantly amended on or after 1 January 2019. Existing securitisations will, generally speaking, continue to be subject to the previous rules, unless new securities are issued or a new position is created in that securitisation transaction. Adding new assets will not, of itself, cause grandfathering to be lost. The detailed transitional provisions will need to be considered in order to understand whether the "new" or the "old" due diligence requirements apply.

The fact that grandfathering rules are based on the date of securities issuance or creation of new liability positions may be problematic for the buy side as that means they need to monitor to identify further issuances. For example, an institutional investor that purchased a credit card master trust in 2018 will not necessarily know when the same master trust issues in 2019 and that as a result, those securities are brought into the new rules. Therefore, processes will have to be put in place to identify when such repeat issuance structures issue further securities, in order to ensure that investors are able to comply with their due diligence obligations. Even where existing securities are brought into the new rules, however, it is only the ongoing diligence rules an existing investor will need to be concerned with. There is no requirement to go back and re-perform pre-investment diligence on existing positions.

There are also slight timing differences between the grandfathering rules under the Securitisation Regulation and the related amendments under CRR, which will be relevant where the investor is a bank or an asset manager investing on behalf of a bank: legacy transactions (those issued before 1 January 2019) continue to be covered by the capital rules of the old CRR regime until the end of 2019, while issuances after 1 January 2019 will be under the new capital rules. From 1 January 2020, everything will be under the new capital rules.

Expanded scope: investors will need to have procedures in place to identify securitisations that are in scope as well as written policies and procedures to comply with the due diligence obligations. For some investors who have historically been subject to regulation of their securitisation investments – such as banks and AIFMs – this may just be a case incremental change. For others – such as UCITS – this will likely necessitate a whole new set of policies and procedures.

Written procedures

Institutional investors must establish written procedures in order to monitor, on an ongoing basis, compliance with the due diligence requirements. These are to be 'proportionate' to the risk profile of the securitisation and 'where relevant', to its trading and non-trading book. Where the underlying exposures are themselves securitisation positions institutional investors shall also monitor the exposures underlying those positions.

Compliance by other parties: The new due diligence requirements will mean that institutional investors need to understand and check on an ongoing basis, not just the requirements that apply to them, but also the requirements imposed on other parties to the transaction e.g. on originators or original lenders.

Written procedures requirements – content

- monitoring of the exposure type
- the percentage of loans more than 30, 60 and 90 days past due
- default rates
- prepayment rates
- loans in foreclosure
- recovery rates
- repurchases
- loan modifications
- payment holidays
- collateral type and occupancy
- frequency distribution of credit scores or other measures of credit worthiness across underlying exposures
- industry and geographical diversification
- frequency distribution of loan-to-value ratios with band widths that facilitate adequate sensitivity analysis

Investments: The new due diligence requirements preclude investment by subject entities in most non-EU securitisations (because it is extremely onerous, though not usually impossible, to structure a non-EU securitisation to comply). However, as some structures marketed as 'securitisations' in other jurisdictions would not be treated as securitisations under the Securitisation Regulation (e.g. single tranche securitisations in the United States which are called "repacks" in the EU and are not subject to securitisation rules), it may nonetheless be possible to continue investing in such overseas structures.

Look-through rules: One of the key issues for asset managers is to understand the 'look-through' rules which apply to their client. As the Securitisation Regulation only applies to 'securitisation exposures', if the client is not required to treat an investment as a 'securitisation' under the applicable look-through rules for prudential purposes, then the due diligence rules won't apply. Accordingly, the investor (and any asset manager acting on its behalf) will be outside the scope of the due diligence requirements. This issue is typically dealt with in the investment mandate.

Delegated due diligence and liability: To reflect the fact that asset managers commonly invest on behalf of institutional investors e.g. an insurer giving a mandate to an asset manager, the Securitisation Regulation permits the delegation of due diligence checks to another institutional investor. The consequence of this is that the asset manager assumes liability for the due diligence.

Asset managers also need to think about their own delegation structures in this context. It is common for both UCITS management companies and AIFMs to delegate (either in part or in whole) portfolio management to other managers or investment advisers, often outside the EU. Asset managers will need to consider whether under the Securitisation Regulation they are permitted to rely on such delegates to carry out the relevant due diligence (as well as ensuring delegates have in place the relevant processes to complete the due diligence).

Is further regulatory guidance expected?

There is no secondary legislation mandated with respect of the due diligence obligations. However, there are a number of areas where regulatory guidance would be helpful, for example in respect of the idea that all of the diligence obligations can be applied on a proportionate basis (widely acknowledged, but for which the official framework is unhelpfully vague) and the precise diligence obligations applicable in respect of investments in third country securitisations. In practice, institutional investors will have to take a pragmatic approach, based on a written policy which describes their approach to compliance, that is consistently followed.

ABCP

In fully supported ABCP programmes, the requirements are slightly different:

Granting of credit – this aspect of the due diligence obligations applies to the sponsor, rather than to any institutional investors in the commercial paper

Due diligence on the securitisation - institutional investors in the commercial paper issued by that ABCP programme must assess the features of that programme and the full liquidity support

Stress tests – the institutional investor must regularly perform stress tests on the solvency and liquidity of the sponsor

Responding to regulatory queries - the institutional investor must be able to demonstrate to its competent authorities, upon request, that it has a comprehensive and thorough understanding of the credit quality of the sponsor and of the terms of the liquidity facility provided

Due-diligence requirements for institutional investors

PRIOR TO HOLDING A SECURITISATION POSITION
The granting of credit
For EU originators or original lenders which are not credit institutions or investment firms, verify that: • the credit giving rise to the underlying exposures has been granted on the basis of sound and well-defined criteria and clearly established processes • effective systems in are in place to apply those criteria and processes in accordance with Article 9 (*Criteria for credit-granting*)
For Non-EU originators or original lenders, verify that: • the credit giving rise to the underlying exposures has been granted on the basis of sound and well-defined criteria and clearly established processes • effective systems are in place to apply those criteria and processes to ensure that credit has been granted based on a thorough assessment of the obligor's creditworthiness
Risk retention
For EU originators, sponsors or original lenders, verify that: • they retain on an ongoing basis a material net economic interest of not less than 5% in accordance with Article 6 *(Risk retention)* • they disclose the risk retention to the institutional investor in accordance with Article 7 *(Transparency requirements for originators, sponsors and SSPEs)*
For non-EU originators, sponsors or original lenders verify that: • they retain on an ongoing basis a not less than 5% material net economic interest determined in accordance with Article 6 *(Risk retention)* • the risk retention is disclosed to institutional investors

PRIOR TO HOLDING A SECURITISATION POSITION

Disclosures

Verify that the originator, sponsor or issuer/SSPE has, where applicable, made available the information as required by Article 7 *(Transparency requirements for originators, sponsors and SSPEs)*

Due diligence on risks of the securitisation

Carry out a due-diligence assessment of the risks involved, including:

- the risk characteristics of the individual securitisation position and of the underlying exposures
- all the structural features of the securitisation that can materially impact the performance of the securitisation position, including the contractual priorities of payment and priority of payment-related triggers, credit enhancements, liquidity enhancements, market value triggers, and transaction-specific definitions of default
- for securitisations notified as STS, the compliance of that securitisation with the requirements. Institutional investors may rely to an "appropriate extent" on the STS notification disclosed by the originator, sponsor and SSPE, without solely or mechanistically relying on this

PERIOD WHILE HOLDING A SECURITISATION POSITION

Written procedures

Establish appropriate written procedures (see box on page 23) on how it monitors compliance with obligations under the Securitisation Regulation

Stress tests

Regularly perform stress tests on the cash flows and collateral values supporting the underlying exposures or in the absence of sufficient data, stress tests on loss assumptions, taking into consideration the nature, scale and complexity of the risk of the securitisation position

Internal reporting

Ensure effective internal reporting so management is aware of the material risks arising from the securitisation position and so that those risks can be adequately managed

Responding to regulatory queries

Be able to demonstrate to regulators on request that:

- it has a comprehensive and thorough understanding of the securitisation position and its underlying exposures
- that it has implemented written policies and procedures for the risk management of the securitisation position and for maintaining records of the verifications and due diligence undertaken and of any other relevant information

SECURITISATION REGULATION: CONSIDERATIONS FOR ABCP CONDUITS

Introduction

The Securitisation Regulation brought in a raft of regulatory changes to the responsibilities (and sanctions) on those involved in establishing and operating both term securitisation transactions and ABCP programmes. In particular, it brought in new disclosure and reporting obligations relating to the sharing of documents and periodic information relating to any securitisation (and the relevant securitised exposures) with investors and any competent authorities supervising such investors or the other parties involved in establishing or managing the securitisation.

From the drafting of the Securitisation Regulation it is apparent that term securitisation transactions and the related issuing securitisation special purpose entity ("**SSPE**") were at the forefront of the minds of the draftsmen; however, this has given rise to a number of lacunae when it comes to interpreting and applying the new requirements to ABCP programmes, particularly when it comes to disclosure and reporting requirements and the related due diligence requirements on investors.

This paper explores a number of those lacunae and considers the approaches that may be taken by those establishing and managing ABCP programmes on the basis of the current legislation.

ABCP programmes

An asset-backed commercial paper programme typically involves a special purpose vehicle (the "**ABCP Issuer**") investing (by providing loans or subscribing for notes) in term securitisation transactions. The ABCP Issuer in turn raises the money it needs to make those investments by issuing commercial paper (typically with relatively short-term maturity – up to 270 days) to investors (an "**ABCP Programme**").

The ABCP Issuer is expected to be able to pay the interest it owes the holders of the commercial paper through the payments it receives from its investments in the underlying securitisation transactions. The sponsoring bank that has established the ABCP Programme will typically make available to the ABCP Issuer a substantial liquidity facility that may be drawn by the ABCP Issuer to the extent that payments from the underlying securitisation transactions are insufficient to meet all the liabilities owed by the ABCP Issuer to those holders of commercial paper. Often this liquidity facility will be sufficiently large to cover all payments of principal and interest that may come due on the commercial paper. Accordingly, holders of the commercial paper can, in effect, treat the liquidity facility as a guarantee of the commercial paper issued by the ABCP Issuer – and will therefore often look primarily to the credit of the sponsoring bank when making investment decisions rather than to the make-up of the cashflow-generating investments held by the ABCP Issuer.

A number of the major global banks have well-established ABCP Programmes, with primarily European and US investors investing in the commercial paper issued.

Application of the Securitisation Regulation to ABCP Programmes

Article 8(4) of the Securitisation Regulation specifies that fully supported ABCP Programmes (assuming they aren't investing in resecuritisations and are not structured in a manner that results in a second layer of tranching at the level of the ABCP Programme) should be treated as "securitisations" for the purposes of the Securitisation Regulation. This is helpful in that it settles the issue of categorisation and, in particular, avoids any confusion over whether they should be considered to be "resecuritisations" which are banned under Article 8. Unfortunately, it also creates a certain amount of confusion and incoherence in the regulatory regime, since a fully supported ABCP Programme looks, in credit terms, not unlike a covered bond – which is not treated as a securitisation at all.

The particular structure of ABCP Programmes leads to a certain level of awkwardness in applying the general Securitisation Regulation obligations – in particular, the disclosure and reporting requirements under Article 7 (and corresponding diligence obligations under Article 5) and the risk retention requirements under Article 6. These

obligations were clearly designed with term securitisations in mind and the adjustments for ABCP, while well-intentioned and often helpful, are not sufficiently detailed and well-adapted to ABCP Programmes to lead to smooth compliance outcomes in all – or even most – cases.

ABCP investor disclosure and reporting requirements

Designated reporting entity

As with term securitisations, Article 7(2) requires one of the originator, sponsor or SSPE to be designated in the ABCP Programme transaction documents as the entity responsible for fulfilling the disclosure and reporting requirements described below (the "**Designated Reporting Entity**").

Given that ABCP Programme transaction documents will not typically have any "originator" as a party, it may become commonplace to see the sponsoring bank of the ABCP Programme (as "sponsor" for the purposes of the Securitisation Regulation) taking on this responsibility as Designated Reporting Entity. Alternatively, the ABCP Issuer (the "SSPE" for the purposes of the Securitisation Regulation) could be named as the Designated Reporting Entity. In these cases, given its typically limited business operations, the ABCP Issuer would almost certainly need to contractually delegate its disclosure and reporting responsibilities to another entity (such as the sponsoring bank of the ABCP Programme or other entity already responsible for preparing and issuing investor reports to the holders of the commercial paper).

Monthly vs quarterly investor reporting

As with term securitisations, the Securitisation Regulation requires that certain information relating to ABCP Programmes be disclosed to investors, potential investors (upon request) and any relevant national competent authorities (together, the "**ABCP Information Recipients**"). This should include information regarding the performance of the ABCP Programme and the underlying exposures of the securitisation transactions that the ABCP Issuer is investing in. However, unlike for term securitisations, the loan-level data and investor reporting must be provided to ABCP Information Recipients on a *monthly* basis (rather than quarterly, as is the case for term securitisations).

When preparing monthly reports, the Securitisation Regulation clarifies that the information relating to the underlying exposures may be provided to investors in the commercial paper on an *aggregated* basis (rather than loan-level as required for term securitisations), which is helpful given the vast number of securitisation transactions the ABCP Issuer may be investing in at any one time and the commercial sensitivity of disclosing some of that information. However, loan-level data must still be provided to the sponsoring bank of the ABCP Programme and, if requested, to the relevant competent authorities. The provision of such loan-level information is a significant hurdle, as many of the borrowers traditionally funded via an ABCP Issuer investment are SMEs or similar businesses for whom finance is not their primary business and who therefore do not have the kind of sophisticated information systems to track and report detailed loan-level data in the way that a bank might do (indeed, must often do) in respect of its borrowers. Notwithstanding such monthly reporting to ABCP Information Recipients, it is worth noting that the (at least) quarterly investor reporting at the level of the underlying securitisations that the ABCP Issuer is investing is still required to take place. As a result, there are two layers of investor disclosure and reporting to be mindful of:

(1) transaction-level: the underlying securitisation transaction in which the ABCP Issuer is investing is itself a securitisation to which the Securitisation Regulation disclosure obligations would typically apply (assuming an appropriate EU nexus that would bring a relevant party into scope);

(2) the ABCP Programme-level: the disclosure at transaction-level described in (1) feeds into the separate disclosure specifically mandated to be made by the ABCP Programme's Designated Reporting Entity to the ABCP Information Recipients.

As a result of the monthly reporting requirement at an ABCP Programme-level, underlying securitisations funded in whole or in part by ABCP Issuers in their investor base may face pressure to increase the frequency of their transaction-level reporting from quarterly to monthly to enable reporting compliance at a ABCP Programme-level. Some sponsoring banks of ABCP Programmes however, are looking at means of complying with monthly ABCP Programme-level reporting using only quarterly reporting at transaction level. It remains unclear whether this approach will gain market acceptance.

Transaction document disclosure and transaction summary

The Securitisation Regulation also requires ABCP Information Recipients to be provided with certain transaction documents and, to the extent the commercial paper is not issued pursuant to a prospectus in compliance with the EU Prospectus Directive (soon to

be Prospectus Regulation), a transaction summary.

While these requirements are clearly intended to apply to ABCP Programmes, the drafting of each has been prepared very much with the typical suite of term securitisation documents in mind, and no separate list setting out the document suite or transaction features typically seen for ABCP Programmes appears in the legislation. As a result, determining which documents are required to be disclosed to the ABCP Information Recipients and which of the features are required to be summarised in the transaction summary to be provided to the ABCP Information Recipients is, in each case, unclear given that many of the documents and transactions featured in the illustrative lists provided in the legislation are simply not applicable to ABCP Programmes.

One possible approach to resolving the uncertainties surrounding the document and transaction summary disclosure requirements would be to approach it purposively, bearing in mind that the document disclosure and transaction summary requirements are most likely to be useful to ABCP investors, rather than the sponsoring bank of the ABCP Programme. Accordingly, you would interpret the requirements as applying at ABCP Programme level rather than transaction level (bearing in mind that all the investors at transaction level will anyway have disclosure of all relevant documents) and rely on both requirements being qualified by the words "where applicable" and the illustrative nature of the lists. The result of that approach would be to only disclose those documents and summarise those features that:

(i) exist at ABCP Programme-level and most closely resemble the transaction-level documents or features listed in Articles 7(1)(b) (relating to document disclosure) and 7(1)(c) (relating to the transaction summary); and

(ii) in keeping with the spirit of the Securitisation Regulation, would achieve the apparent purpose of the disclosure requirements by ensuring that ABCP investors have all documents "essential for the understanding of the [ABCP Programme]" and the summary summarises the "main features of the [ABCP Programme]"

Given the uncertainty that surrounds the document and summary requirements in relation to ABCP Programmes some uncertainty remains, but this would appear to represent a sensible balance between practicality and attempting to comply with the substantive outcomes mandated by the legislation.

ABCP risk retention compliance

The risk retention methodology set out in Article 6 remains largely unchanged from the risk retention methodology set out in the previous sectoral regimes. Under the previous risk retention regime, ABCP Programmes often satisfied the risk retention requirements via the sponsoring bank's provision of the supporting liquidity facility which can be treated as a vertical tranche under retention option (a)[1] or a first loss tranche under retention option (d)[2].

Also similar to the old regime, the risk retention method being complied with by the ABCP Programme must be disclosed in the monthly investor reports to ABCP Information Recipients.

An interesting issue arises around the substantive requirements relating to risk retention on ABCP Programmes, however. There have historically been differing views in the market as to whether risk retention is required at both ABCP Programme-level and at transaction-level or whether a single "layer" of compliance would be sufficient. In practice, the question often doesn't arise, in light of concerns that it would not be possible or practicable to disclose transaction-level retention details (including the identity of the retainers) to

1 As confirmed under Article 5 of the existing regulatory technical standards: Commission Delegated Regulation (EU) No. 625/2014. The new regulatory technical standards that are yet to be adopted in connection with the Securitisation Regulation are not expected to substantively alter these risk retention options for ABCP Programmes.

2 As confirmed under Article 8 of the existing regulatory technical standards: Commission Delegated Regulation (EU) No. 625/2014. The new regulatory technical standards that are yet to be adopted in connection with the Securitisation Regulation are not expected to substantively alter these risk retention options for ABCP Programmes.

ABCP Information Recipients. However, for sponsoring banks who view themselves as sponsors of the individual transactions funded by their ABCP Programme – and therefore eligible to hold the retention in respect of them – it may be worth considering whether a single layer of retention (in the form of transaction-specific liquidity facilities provided by the sponsoring bank) might be sufficient to cover the point. Interestingly, the European Securities and Market Authority appears to suggest in the most recent version of its Q&A document[3] that a single layer of retention would indeed be sufficient.

STS ABCP Programmes

The Securitisation Regulation contemplates that both term and ABCP securitisations should be eligible for categorisation as "simple, transparent and standardised", or "STS" – a designation which may afford the relevant investors with better regulatory capital treatment.

While STS ABCP Programmes are theoretically possible under the Securitisation Regulation, few if any sponsoring banks in the market are seriously considering taking this route given the significant challenges to achieving compliance. One of the principal difficulties is the requirement that *all* underlying securitisation transactions that have been funded through the ABCP Programme must themselves be STS securitisations (subject to a 5% margin for error at any given point designed to allow for a small volume of transactions temporarily being non-compliant at any given time). The achievement of STS status for ABCP Programmes is made even more difficult by the requirement for all originators, sponsors and SSPEs involved in an STS ABCP Programme to be established in the EU and by the apparent requirement that all transactions funded by an STS ABCP Programme must be securitisations.

For well-established ABCP Programmes that already fund a significant number of securitisation transactions (the majority, if not all, non-STS securitisations) it seems unlikely that those ABCP Programmes could achieve STS status; however, if the investor regulatory capital treatment of an STS ABCP Programme were deemed sufficiently attractive for the sponsoring bank to arrange, steps may be taken to either: (i) establish new ABCP Programmes investing solely in STS securitisations or (ii) transfer positions in STS securitisations *into*, and/or transfer positions in non-STS securitisations *out of*, existing ABCP Programmes to ultimately achieve a fully STS ABCP Programme.

It remains to be seen the level of uptake there will be in establishing STS ABCP Programmes given the stringent requirements.

3 See question 5.12.13 of the Q&A document dated 27 May 2019, available here: https://www.esma.europa.eu/sites/default/files/library/esma33-128-563_questions_and_answers_on_securitisation.pdf

SECURITISATION REGULATION: NON-ABCP RECEIVABLES TRANSACTIONS

Financing of trade receivables is done in a number of ways that may or may not constitute a "securitisation" for regulatory purposes, and may be funded either via ABCP conduits (as to which see the previous article) or otherwise (which we will refer to, for simplicity, as being "on balance sheet"). In this article, we review the issues surrounding these on balance sheet receivables finance transactions arising out of the Securitisation Regulation and how they might be dealt with.

One of the reasons the Securitisation Regulation frequently causes issues for these types of transactions is that for many of the parties to the deals, their transactions have never been thought of as being in the securitisation space and have previously been entirely unregulated. This will frequently have been for jurisdictional reasons; transactions might historically have been outside of both the US regulatory regime (for example, because they do not involve the issuance of "securities") and outside the European regulatory regime (for example, because investors were exclusively in third countries or the investor base was made up of entities not subject to the old sectoral legislation relating to securitisations). It equally may just have been a case of increased pressure being put on the securitisation analysis (as we have pointed out elsewhere) due to the expanded scope of securitisation regulatory obligations and more severe penalties in place for breach. Whatever the reason, the expanded scope of the regulations governing securitisation in the EU raises a number of complicated questions for market participants.

Is it in scope?

Is it a "securitisation"?

One way in which the Securitisation Regulation is much broader that its predecessor regulations is that it applies not only to various types of regulated institutional investors in securitisations, but across the board to any in-scope entity issuing, originating, sponsoring or investing. The definition of a "securitisation" is functionally identical to that used under the previous regime, however, many more parties are now having to consider whether they are party to one. While there are some receivables financing transactions which will fall within the scope of the Securitisation Regulation, there are many that will not. So what are some of the features of these transactions that might take them outside of the regulations?

The presence of corporate credit support of some kind (a credit insurer, originator guarantee or otherwise) supporting the transaction may mean that the credit risk in the deal is dependent on something other than the performance of an underlying pool of exposures – and therefore not a securitisation. For this to be true, the investors in the transaction have to be in a position to conclude that their principal credit risk is corporate; that is, their judgment of the "correct" way to analyse the transaction must be as a secured corporate risk, not principally as an analysis of the underlying asset credit. One way this might be achieved would be a guarantee from the originator to make the investor(s) whole for any losses suffered on receivables put into the transaction.

Factoring, equally, will not generally be a securitisation for regulatory purposes, because the receivables are sold with no junior risk retained by the originator and therefore no tranching. Indeed, non-ABCP receivables transactions are frequently bilateral arrangements which, structured correctly, may mean that even the apparent presence of different "tranches" of credit risk does not cause the transaction to be a securitisation because (and for so long as) all tranches are owned by the same investor.

In practice, the question of whether a receivables transaction is a "securitisation" will frequently not be clear cut and the parties may be required to take a nuanced view based on the facts and circumstances of the particular arrangement. The result of some of this uncertainly and complexity is that different parties on the same transaction may end up taking different views as to whether their arrangement falls within the regime or not. Parties to a transaction forming different views as to whether the legislation applies is not unique to non-ABCP receivables transactions, nor is it new under the Securitisation Regulation. The issue is that the well-trodden path of different banks taking different views of the regulatory status of transactions (and it has historically principally been banks) comes up against new challenges under the new regime. No longer is it a case of simply tweaking the documentation to formalise retention of junior risk by a corporate originator that was anyway commercially agreed. Accommodating any transaction party's conclusion that the transaction is a securitisation now requires the disclosure of large volumes of loan-by-loan data that a typical corporate originator would not be set up to collect, let alone report in the required format – originators in this space may never have provided any sort of detailed

reporting for their transactions before. Banks and other investors in these transactions, on the other hand, will wish to take a consistent approach across their book – a key element of good practice that regulated entities need to demonstrate they have made reasonable efforts to comply with regulation.

Grandfathering

The Securitisation Regulation applies to transactions under which securities are issued (or, where there are no securities issued, new securitisation positions created) on or after 1 January 2019. As such, grandfathering provisions relate to the liabilities side of the transaction rather than to changes in the underlying pool of exposures. Helpfully for receivables financing deals established before 1 January 2019, this means that the addition of new exposures to the underlying pool, in order to continue to meet borrowing base tests, for example, or the repurchase of ineligible assets will not (alone) bring a transaction within the regime.

That leaves open, however, the question of what happens where the terms of the funding provided under a "grandfathered" transaction are amended. The answer will depend on the changes made and whether such changes can be said to constitute the issuance of new securities or creation of a new securitisation position. The extension of a facility limit or the increase of the maximum commitment under a VFN are both likely to cause the loss of grandfathering. Extensions of term, for example, are a more difficult question. It is common for receivables transactions to have a maturity date of around 365 days, with the intention that the funding will, at its original maturity, be rolled into new 365 day funding on the same terms and under the same documentation. This may even be provided for as an option for the parties in the original documentation. There is a debate in the market about whether such extensions would be sufficient to lose grandfathering. The consensus around these difficult situations is only that each case needs to be examined on its facts. However, a widely-accepted rule of thumb is that, if investors would be required in the normal course to obtain credit approval for the proposed changes, that is an indicator that the change is significant and might be sufficient to cause loss of grandfathering.

Disclosure obligations

Quarterly reporting

Once the parties have decided that a transaction is (or will be treated as being) in scope, there are still more questions. Specific reporting templates haven't been published (even in draft form) for non-ABCP receivables transactions so parties will have to make a judgment call about the most appropriate way to approach reporting. Market participants in other asset classes have, while awaiting confirmation of final reporting templates, commonly decided to proceed with reporting as "business as usual" based on reporting provided on precedent transactions or before whichever new issuance brought the deal into the scope of the Securitisation Regulation (including, where applicable, relevant templates prepared under CRA3). This won't always be an option for receivables transactions as there will not always have been a relevant CRA3 template, particularly for private transactions. Indeed, such transactions may never have included contractual reporting requirements or, if they did, these may have been far from resembling the reporting under the other draft templates published by ESMA for the purposes of the Securitisation Regulation.

In practice, parties are taking (and have no option but to take) a pragmatic approach. While technical compliance with the letter of the Securitisation Regulation is rendered impossible (for the time being) due to the lack of clarity around templates, parties should make efforts to comply with the spirit of the legislation. ESMA has issued a statement indicating that a "proportionate" and "risk-based" approach should be taken in the context of disclosure obligations, particularly where CRA3 templates have not previously been used as the basis for reporting in a transaction. This has allowed investors, originators and issuers to conduct common-sense based discussions as to what level and format of disclosure is appropriate for particular transactions and gives some comfort that competent authorities should not apply the disclosure rules without considering what is appropriate in the context of the particular transaction. What is still left unclear, however, is what exactly "proportionate" disclosure looks like for a receivables transaction, given some transactions will have had little or no reporting previously.

Things will not necessarily be clear for receivables financing transactions even once the ESMA templates for reporting are finalised. Based on the current drafts, and depending on the nature of the transaction, different templates may be deemed most appropriate – and indeed the drafts produced by ESMA explicitly contemplate the possibility that more than one template may need to be used on a given transaction where there are different asset types being financed in a single deal. The risk of this is made more acute because there is no dedicated template for reporting on trade receivables or for receivables financing transactions more generally. Certain transactions may find that reporting on the "esoteric" template makes most sense; for others the "corporate" or "consumer" template may prove the best fit, though neither was designed with trade receivables in mind and so these are almost certain to produce some awkward outcomes. In any case, it is likely that the number of fields marked as not applicable (or "No Data") may need to be significant, at least initially.

Confidentiality

The tension between disclosure compliance on the one hand and respecting confidentiality on the other is present in relation to a range of different asset classes but, again, may cause particular headaches for those involved in receivables financing transactions. For asset classes where reporting has been required and customarily provided for some time, contracts governing the underlying exposures will typically be drafted with the disclosure of information in connection with a possible securitisation in mind. Contrast that with contracts which have typically been the subject of, for example, factoring in the past. Frequently, the underlying obligor is not aware that their receivable has been factored and there may not be provisions in the documents allowing for disclosure in order for the originator to comply with (previously irrelevant) regulations in relation to securitisations. In addition to this, data in relation to exposures underlying a trade receivables securitisation may be particularly commercially sensitive. Some of these issues are explicitly acknowledged and, to some extent, dealt with in the text of the Securitisation Regulation. For example, the recitals recognise explicitly that an important feature of private securitisations is that they allow for finance to be raised without the disclosure of potentially commercially sensitive information. The operative provisions relating to disclosure also acknowledge the existence of confidentiality obligations and provide as a solution that confidential information may be aggregated or summarised. This, however, does not appear to be reflected in the loan-level and investor reporting templates prepared by ESMA, leading market participants to wonder how best to comply with both the forthcoming detailed disclosure rules and their obligations of confidentiality, whether contractual or imposed by law.

Transaction summary

Where a formal (Prospectus Directive, soon to be Prospectus Regulation) prospectus hasn't been drawn up for the transaction (which will be the case for most receivables transactions, which are often private deals), a transaction summary must be produced. The transaction summary is required to include details regarding the structure and diagrams explaining cashflows and ownership as well as details of the voting provisions, waterfalls, credit enhancement and liquidity support features. Where one has been produced, a term sheet can be a starting point for the preparation of such a summary, however, there won't always be a term sheet and, where there is, turning it into a summary may require a significant amount of work. This begs the question, for whom is the summary being prepared? For a bilateral transaction or a deal with a small number of investors who have all been heavily involved in the negotiation of the transaction, none of the commercial parties would typically have much use for it. There will be private transactions where the universe of potential investors, to whom the summary must also be made available, is equally small. There are no provisions in the Regulation which allow for investors or potential investors to waive this right to receive or have access to such a summary document and so originators, sponsors and issuers will be required to produce something that will go unread unless one of the relevant competent authorities (who also have a right to receive it) decides to ask for it. This reflects an overarching question in relation to disclosure for receivables financing transactions; where no contractual (or regulatory) disclosure was previously provided, are the investors being furnished with information they simply do not want or need? Is the preparation of all this data just in case a competent authority might ask for it really a sensible way to regulate private transactions?

Conclusion

While there are some non-ABCP receivables financing transactions which the parties will want to bring within the ambit of the Securitisation Regulation, many will not sit comfortably within the regime. Many market participants in the receivables financing space have only begun to sit up and pay attention to the regime brought in by the Securitisation Regulation recently. They are still getting to grips with what is required from them and from other transaction parties but this process is not helped by that fact that almost six months on from the implementation of the new regime, it is unclear in certain important respects. Originators, sponsors, issuers and institutional investors are left in a position where they can't always be certain as to what they are required to do in order to comply and may find it challenging to agree on whether compliance is necessary or desirable in the first place. Some steps, including assurances from the European Supervisory Authorities on the interim approach to disclosure, have gone some way towards providing guidance for the market on certain outstanding questions, however, more work needs to be done by regulators and doubts resolved quickly if the new regime is to provide a clear framework for securitisation of receivables in the EU.

SECURITISATION REGULATION: AIRCRAFT FINANCE CONSIDERATIONS

In a number of areas[1], one of the key impacts of the Securitisation Regulation is to put more pressure on existing questions around whether an arrangement is a securitisation for EU regulatory purposes. These areas tend to be characterised by certain securitisation-like features (e.g. limited recourse to assets, tranching) making judgments difficult and heavily dependent on the particular facts of the arrangement and even the parties' own analysis of the credit and cashflows. Aircraft financing transactions are very much in this category of financing arrangements. In this article, we consider the features that might cause an aircraft finance deal to be (or not be) a securitisation.

Prior to the introduction of the Securitisation Regulation, it was not uncommon for aircraft finance deals to comply on a "just in case" basis where the securitisation analysis was difficult. Historically, parties would have been inclined to put in place securitisation compliance provisions in case the relevant financing was ever considered to be a securitisation in accordance with the relevant sectoral securitisation rules. The decision to provide for such securitisation compliant provisions was driven by the low cost of compliance (which was mainly centred around risk retention), since the sponsors (in the commercial, rather than regulatory sense) tended to hold a junior piece on the transactions anyway. The "just in case" compliance approach is still possible, but no longer as low-cost as it once was, given the onerous obligations imposed by the Securitisation Regulation.

An alternative approach that used to be available was to exclusively market the transaction to non-EU investors on the basis that the old securitisation framework was more or less entirely investor-focussed. This approach is no longer available. It is, of course, possible to escape the scope of the Securitisation Regulation by structuring deals with no EU nexus whatsoever but this is not always possible or practical.

Because the time-honoured "fudges" that permitted parties to avoid the need for a firm conclusion on the question of whether a particular transaction is a securitisation are no longer available, we look again at the factors driving the analysis through some worked examples. Broadly speaking, though, aircraft financing deals are likely to fall into one of three categories: securitisation, corporate exposures, or specialised lending.

The first article in this section discusses the definition of a securitisation extensively, so reference should be had to that article for the theoretical background to the examples-based discussion below.

Examples of common structures

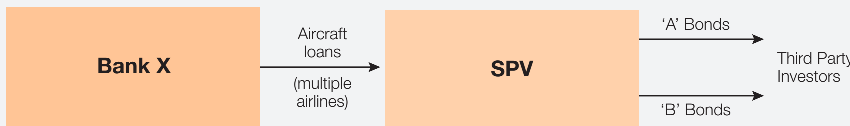
Although specialised lending exception is designed for aircraft finance, it's not always desirable to structure transactions in that way. These decisions may be driven by regulatory (including regulatory capital) considerations or broader commercial considerations. The examples set out below illustrate the significance of different fact patterns in determining whether an aircraft financing transaction is a securitisation, specialised lending or corporate exposure.

It is important to note that slight variations in any aspect of an aircraft financing transaction may impact the assessment as to whether such transaction is a securitisation and, as such, changes in fact pattern would necessitate a new analysis of the transaction as a whole.

Example: aircraft loan financing

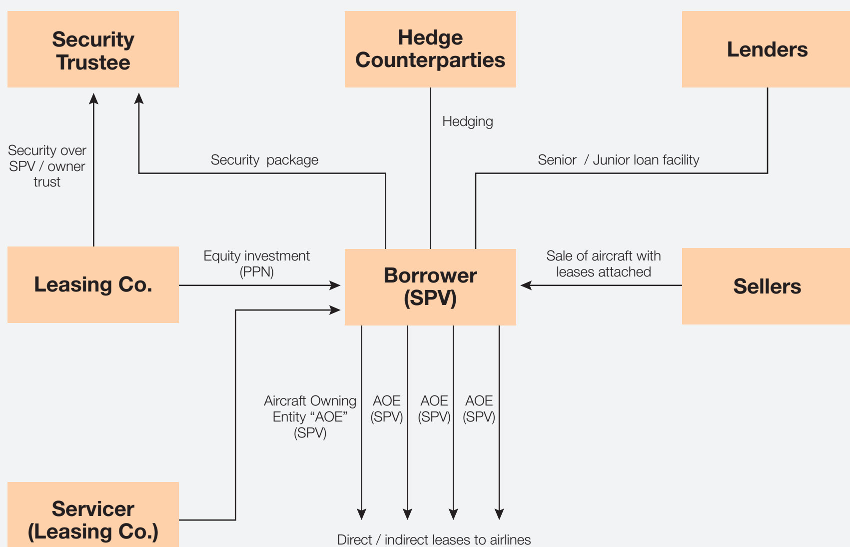
In this example (see structure diagram overleaf), the aircraft loans may well have been specialised lending (or indeed corporate) exposures when originated by Bank X, but the repackaging and retranching of these loans via the SPV will almost certainly constitute a securitisation, with Bank X as originator. In that sense, the analysis is much the same as if the underlying loans had been residential mortgages or auto loans. The very fact of an underlying loan being used to finance aircraft is not sufficient to bring any further arrangements to finance that loan out of the securitisation regime, even if the underlying loan is specialised lending. Even if all the aircraft loans had been to a single airline, or indeed where the underlying was a single aircraft loan, there is no guarantee the third party investors would avoid having a securitisation exposure. Although those cases might have been specialised lending in the hands of Bank X, there would typically be some difficulty establishing sufficient lender

1 See the articles in this section entitled "Non-ABCP receivables transactions" and "NPL financing: a securitisation?" elsewhere in this section.

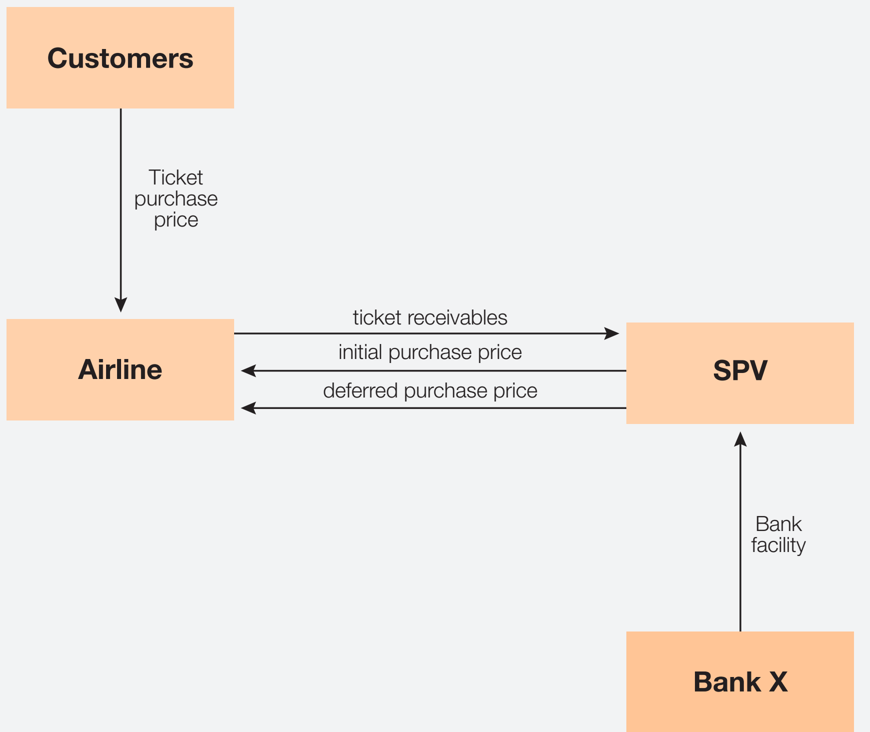


control over the assets and the income they generate where the ultimate lenders are bondholders. The level of control typically expected in a specialised lending transaction would prove impractical to be exercised by a large and changing group of creditors.

Example: operating lease portfolio financing
This transaction would most likely be treated as a corporate exposure, but might also be a securitisation. Specialised lending is unlikely because it would again be difficult to demonstrate sufficient lender control in this example, and anyway income is primarily generated from leasing and re-leasing aircraft rather than their direct operation. Having ruled out specialised lending, it is worth examining the securitisation analysis. There is tranching, and the recourse of the lenders is likely to be limited to the income produced from the leases, which could sensibly be thought of as your pool of underlying exposures. *Prima facie*, then, you could make a case that there is a securitisation. That said, in these cases, the judgment call will turn very heavily on the role of the servicer and the breadth of its powers. If the servicer has extensive powers to lease and re-lease aircraft on financial terms (tenor, price, etc.) that are largely within its control, there may be a good case that the payments on the transaction depend not on the performance of a pool of exposures but instead on the management capabilities of the servicer. Accordingly, the better view might be that the lenders have a corporate exposure rather than a securitisation exposure. Another factor to consider is whether there is a correlation between the winding down of the aircraft leases and the amortisation of the debt obligations. If there is, that points toward the transaction being a securitisation, in the style of, say, a managed CLO. Finally, we would take into account whether the portfolio of aircraft leases is a fixed pool (more likely to be a securitisation) or a dynamic portfolio of leases and re-leases (less likely to be a securitisation, subject to the other factors described above).



Example: ticket receivables financing
This final transaction (see diagram on page opposite) would most likely be treated as a securitisation. On these facts, Bank X lends money to the SPV, which acquires the right to a stream of ticket receivables from the airline. The SPV's purchase price to the airline is structured as an initial purchase price based on 80% of the value of the receivables, with a deferred element reflecting the other 20%. The amount of the deferred purchase price actually paid will depend on the level of defaults by customers. Although not accomplished by the usual explicit means, the result is that the bank has what is effectively an 80% senior exposure to the receivables from the customers, with the airline retaining a 20% junior tranche. The distribution of any losses would happen as the defaults on the ticket receivables occurred, meaning the distribution of losses would be determined by the tranching in the deal during its ongoing life.



Conclusion

There is greater pressure on market participants to clearly identify whether an aircraft finance transaction is a securitisation due to the more onerous requirements under the Securitisation Regulation and the expanded scope of regulation it introduces. A number of factors will affect the judgment on aircraft finance arrangements, and the decisions will often be finely balanced, with small changes in facts leading to potentially very different regulatory outcomes. This is further complicated by the fact that different parties may be motivated to come to different conclusions. While it is still permissible for different parties to treat the same transaction differently in many cases, the costs of doing so are now higher than they were.

SECURITISATION REGULATION: PORTFOLIO ACQUISITIONS AND ARTICLE 9

In the last year or so we have seen significant portfolio disposals across a number of jurisdictions, including the UK (where UKAR has continued its programme of disposals of the legacy Northern Rock and Bradford and Bingley mortgage books, in particular) and Ireland (where Lloyds Bank, KBC, Danske and Rabobank have all sought to exit their Irish mortgage businesses). Many of these legacy mortgage portfolios are extensively seasoned and often predominately originated before the financial crisis in accordance with the standards of the time. Although much is known about the credit characteristics of these books (due largely to extensive seasoning), the passage of time often means that access to the origination policies relevant at the time and personnel familiar with the origination of the book can be difficult or patchy. These problems become even more acute where portfolios are made up of assets from multiple originators brought together through merger or otherwise.

In this context, Article 9 of the Securitisation Regulation has since 1 January of this year presented some complex issues, especially given the frequent use of securitisation exits made by portfolio acquirers.

Article 9(3) is the most relevant part of Article 9 for acquired portfolios. It provides that where an originator purchases a third party's exposures for its own account and then securitises them, that originator has to check that the asset creator (normally the original lender) applied the same origination standards to the securitised assets as to non-securitised exposures. The originator must also verify that there were clearly established processes around extending, amending and otherwise administering the securitised loans, as well as for checking the obligor's creditworthiness. Clearly, there are challenges for acquirers of historic mortgage pools in meeting these requirements, but fortunately there are sensible ways of approaching them in a manner workable for the mortgage trading market. It should be noted that there is a marginally easier version of the requirement to meet for where the mortgages to be securitised were originated before the 21 March 2014, but the differences are not significant.

The first part of the Article 9(3) test should be the most manageable. While the wording on its face suggests a test that might be quite onerous (because you would need detailed knowledge of the origination of both the assets proposed to be securitised and contemporary non-securitised assets), the spirit of the provision is actually much more straightforward to comply with. Essentially, Article 9(3) amounts to a requirement on the originator to establish that the pool of mortgages was not created as an 'originate-to-distribute' pool. Due diligence at the point of acquisition should in most cases be able to establish this by looking at factors such as pool selection and loan features. The key test here is the difference between approaches taken to securitised and non-securitised exposures. The test is even easier where all of the assets within a defined business line are sold, as this reinforces that different criteria could not have been applied to securitised and non-securitised exposures.

For portfolios that were originated in the context of an originate-to-distribute business model, it may be that the situation can be remedied by e.g. re-underwriting the relevant loans. Portfolio acquirers will need to look at the detail of the origination standards and criteria at the time and consider carefully how to approach the Article 9(3) issues lest they find themselves unable to access the securitisation markets for financing.

The second part of the test, in relation to clearly established origination processes, is more complex as it involves more subjective and portfolio specific analysis as to current performance. The requirements of the second part of Article 9(3) require an assessment and consideration of the exposures to be securitised and their current performance characteristics in order to verify the prospect of the relevant underlying obligor meeting its obligations under its credit agreement. It will be important for portfolio acquirers to record the diligence in this respect and to identify any issues that have arisen from that diligence, including any gaps in the diligence that could be undertaken. It is expected that

practice will develop such that the gaps are reflected in the disclosure in the prospectus. In this way, the spirit of the legislation can continue to be met, by ensuring that investors have (as much as possible) the same information as originators when making investment decisions. The adequacy of the level of disclosure should be considered by reference to the nature of the portfolio and market practice.

Due diligence in relation to original lending practices is therefore key and originators will need to take into account the circumstances relating to the purchase of the assets and the type of securitisation. Factors will vary across portfolios, including any collateral, seasoning, delinquency, and restructuring arrangements/payment plans, etc. Accordingly, portfolio acquirers will need to be careful to ensure they meet or exceed prevailing market standards of due diligence on the current nature and performance of the exposures and use best efforts to obtain as much information as practicable in order to make their assessment (and inform disclosure to investors) on factors such as collateral values, legal and regulatory framework of the exposures, loan and servicing documentation and performance in order to satisfy themselves that they have complied with the requirement to "verify" both the origination standards and credit processes. In other words, following best practice in the market and using best efforts to obtain and work through the available materials on the portfolio will be key tests for portfolio acquirers to bring securitisations to market backed by pools of historic mortgages.

The disclosure of diligence by portfolio acquirers will also be helpful for investors who are themselves subject to due diligence obligations under the Securitisation Regulation. Except where they can rely on the EU-regulated status of an originator or original lender, investors will also have certain obligations to verify that the assets were verified according to "sound and well-defined criteria" as well as checking certain requirements are met around processes for originating and administering the underlying assets.

The result of both the acquirer and investors having requirements to check origination is likely to be that transactions will have a further increased focus on these origination criteria and processes and how these are disclosed, either in offering materials or (where there are none) in financier shadow diligence for private securitisation transactions.

While Article 9(3) is looking more manageable to comply with than initially feared, much of this is based on informal discussions and guidance with regulators. We understand the European Banking Authority (together with the other European Supervisory Authorities) are working on formalising some of this guidance. Given the concern market participants have in relation to mortgage portfolio acquisitions, such guidance would be welcome in order to clarify the basis upon which transactions can sensibly proceed while complying with these new obligations. We would encourage the authorities to publish that guidance as soon as practicable in order to provide greater legal certainty and promote efficient markets.

SECURITISATION REGULATION:
NPL FINANCING – A SECURITISATION?

In this article, we examine some of the recent issues relevant to the non-performing loan ("**NPL**") market and certain issues faced in NPL transactions under the new Securitisation Regulation regime. In addition, we will discuss some current issues in the Spanish NPL market as well as some key features of NPL transactions, both from the perspective of those acquiring portfolios and their financiers, which is particularly relevant as existing techniques initially developed in jurisdictions such as Ireland and Spain are deployed in markets now seeing increasing volumes of trades such as Portugal and Greece.

2018 was yet another record year for the number and value of completed NPL transactions in the European loan markets. According to Debtwire[1], reported gross book value of closed transactions across Europe reached EUR 205 billion, with the most active jurisdictions once again being Italy and Spain. As in prior years, these record numbers continued to be driven largely by a demand from banks to reduce their balance sheet NPL exposure coupled with the continued appetite of experienced NPL sponsors to invest their capital in seeking potentially significant returns.

So far in 2019, the NPL markets have continued to be very active and, along with Italy and Spain, both Portugal and Greece have seen increasing levels of current and proposed transactions. Most market commentators seem to agree that 2019 will not see a repeat of the record-breaking transaction volumes of 2018, but the reported numbers of NPLs that remain on bank balance sheets throughout Europe and the continuing regulatory focus on European bank exposure to NPLs suggests the NPL market can expect significant activity throughout 2019 and beyond[2].

NPL transactions – not always securitisations

As with more traditional forms of securitisation, since 1 January 2019 those active in the NPL financing markets have had to take account of the Securitisation Regulation.

One of the key questions to be asked in any NPL transaction is whether the transaction is a securitisation for regulatory purposes at all. While most NPL portfolios are acquired with some form of tranched debt financing, many portfolios being traded have key features that would suggest that such financings are not securitisations despite the presence of tranched debt. Two common situations in NPL financing include:

- **Portfolios that are mostly in REO (or "real estate owned") form:** that is, the real estate originally securing loans that has been foreclosed against is now owned (normally indirectly) by the loan creditor. This also includes portfolios that consist of a significant number of REOs with the remaining NPL exposures having already taken the form of executable court judgments or loans in respect of which enforcement action has been or will be taken. In these cases, there is a real question as to whether the payments to the creditors can be said to be "dependent on the performance of the pool of exposures". If that is not the case, then the transaction is not a securitisation for regulatory purposes. To the extent all or substantially all of the portfolio is REOs, there is an even stronger argument that the predominant nature of the portfolio is not in fact credit exposures at all, but exposure to real estate. Since securitisation requires tranching of *credit* risk on the underlying assets, the absence of underlying credit risk would prevent there being a securitisation more or less regardless of the structure of the financing overlaid on it.
- **Portfolios that consist largely of loans in significant distress:** that is, loans which require active management and workout. The basis of the argument in this case is that the payments on these transactions are less dependent on the performance of the exposures themselves because the primary driving factor will be the ability of the sponsor and its servicer and asset manager to successfully execute the business plan to recover maximum

1 European NPLs – FY 2018 – an overview of the non-performing loan market
http://www.debtwire.com/pdf/EuropeanNPLFY18!.pdf

2 See, for example, the European Parliament briefing of October 2018 "*Non-performing loans in the Banking Union, Stocktaking and challenges*"
http://www.europarl.europa.eu/RegData/etudes/BRIE/2018/614491/IPOL_BRI(2018)614491_EN.pdf

value through enforcement or quasi-enforcement processes. On this analysis, the credit risk of the financing is more akin to a corporate credit risk than to the any intrinsic credit risk on the underlying portfolio of credit assets because an analysis of the credit quality of the underlying assets alone would produce a misleading conclusion as to the likely returns.

These, however, are broad illustrations of the types of analysis that might be undertaken on NPL transactions, rather than one-size-fits-all solutions. The particular individual approach to this analysis is something that needs to be carefully considered on a case-by-case basis taking into account the nature of each individual portfolio.

The impact of the Securitisation Regulation

Since the Securitisation Regulation began to apply on 1 January 2019, even more pressure has been put on the analysis of whether a transaction is a securitisation or not. This is for two principal reasons. First, the consequences of failing to comply when a transaction is a securitisation have become far more severe. Second, the historical approach of complying with securitisation rules on a "just in case" basis has become far more costly and difficult since the introduction of the more onerous regime under the Securitisation Regulation.

Nonetheless, and sometimes out of an abundance of caution, a number of NPL transactions have been completed which have been structured to be compliant with the requirements of the Securitisation Regulation. On these transactions, compliance with certain aspects of the Securitisation Regulation has raised practical issues, particularly the Article 9 verification requirements as well as loan-level reporting obligations.

The issues around acquired portfolios described in the previous article typically apply to NPLs just as they would to any other portfolio. That is, most NPL financing transactions, whether financed through private bank debt or on the capital markets, are put together to finance the acquisition of an NPL portfolio rather than to finance a portfolio that is remaining on the balance sheet of the NPLs' originator. While in some NPL acquisitions since the coming into force of the Securitisation Regulation, buyers have sought representation and warranty coverage from the seller to give comfort that the Article 9 requirements were satisfied at the time of origination, this is not something that is always forthcoming, especially where the seller is a financial institution in the process of winding-down business lines and divesting assets. In addition, from the perspective of those acquiring NPL portfolios and their finance providers, the origination criteria have historically been an aspect outside of the detailed due diligence performed ahead of acquisition, which has to date concentrated on the legal, valid and binding nature of the loans acquired, the robustness of the underlying loans' security and any other issues that would impede or delay the implementation of the workout plan. Indeed, it is sometimes hard to see the value of knowing the historic underwriting criteria for assessing credit risk and likelihood of repayment in the context of acquired NPL and REO portfolios. In this context, the hoped for guidance that focusses on Article 9(3) as an anti-originate-to-distribute measure would be especially helpful and welcome in the NPL markets.

As to reporting, the loan-level and investor reporting templates published by ESMA most recently on 31 January 2019 are not yet final. If, as expected, there is no material deviation from those forms when the final templates are settled and published, there are a number of practical issues around disclosure – and loan-level reporting in particular – for NPL financings that are securitisations for regulatory purposes. Helpfully, the data fields in the specific annex dedicated to non-performing exposures broadly correspond to that which is typically available and relevant when a loan is in an enforcement process. However, the non-performing exposure reporting template is an add-on that must be completed alongside the main loan-level reporting template for the asset class in which the original loan would have been categorised. The first issue with this approach is that many of the data fields required by the RMBS, CMBS and consumer asset related templates simply will not be available for those loans that are deeply in distress or in an enforcement process. Even if limited information is available, it is likely to be of far less relevance given continuing enforcement processes (the income of the principal obligor at the time of loan origination isn't very relevant, for example, once the loan is in enforcement). In addition, many NPL portfolios consist of a wide variety of loan types meaning that it may be necessary to report using a variety of templates (in addition to the non-performing exposure template) for a single transaction. This is also a particular focus for portfolios that consist of a mix of loans and REOs – the latter are not easily categorised into any of the draft reporting templates, including that for non-performing exposures. It is therefore hoped that practical solutions can be found with respect to reporting on NPL portfolios – possibly to do with the circumstances under which use of "no data" responses is accepted. The market

is keen to provide transparency, but this should take the form of providing pertinent information to the extent it is available, with gaps in the information highlighted such that sophisticated investors can make an informed decision about the risks associated with those gaps.

Recent developments in the Spanish NPL market

On 26 March 2019, the Court of Justice of the European Union (Grand Chamber) ("**CJEU**") issued a long-expected judgment (joined cases C-70/17 and C-179/17) regarding the validity of early termination clauses in Spanish mortgage loans. This, together with the publication of Law 5/2019[3] (the "**Real Estate Credit Agreements Law**") which will come into force on 16 June 2019, will have an impact on the servicing and enforcement of Spanish NPL portfolios.

The CJEU ruling confirms that an early termination clause which allows any breach of the loan contract by the borrower to constitute an early termination event is unfair and therefore unenforceable. The CJEU has directed the case back to the Supreme Court of Spain, which must now rule on whether a mortgage contract can continue in existence if that unfair term is removed and on the consequences of its removal to the consumer. In its judgement, the CJEU has left open the possibility that the Spanish Supreme Court could replace the early termination clause with a supplemental provision of national law (in this case, article 693.2 of the Spanish Civil Proceedings Law) which allows for an acceleration where there has been a minimum of 3 months' worth of missed payments. For this substitution to apply, certain criteria need to be satisfied, namely:

- the removal of the unfair early termination event would require the court to annul the entire mortgage loan contract; and
- the consumer would therefore be exposed to particularly unfavourable consequences.

The outcome of the Supreme Court decision will therefore have significant repercussions for many Spanish mortgage loans which have already been accelerated using the (unenforceable) broad early termination clause, many of which are currently in a stay of proceedings pending the decision.

The Real Estate Credit Agreements Law provides a solution to this issue for mortgage loans that have not yet been accelerated prior to the law coming into effect. Under the new law, lenders will be able to accelerate where either during the first half of the term of the loan, there are either 12 monthly repayment defaults (or 3% of the total loan borrowed) or during the second half of the term of the loan, there are 15 monthly repayment defaults (or 7% of the total loan borrowed).

NPL transactions – techniques and themes

During 2018 and to date in 2019, there has been an increasing use of securitisation to finance the acquisition of NPL portfolios. In previous years, the vast majority of NPL transactions were structured as private acquisitions financed by a senior loan which was then typically syndicated to a small number of investors who remained in the transaction to maturity. The exceptions were some of the large UK and Irish disposals of performing and near-prime residential portfolios which were securitised at the point of acquisition or shortly thereafter. While such transactions are still commonplace, the market is seeing more and more transactions, particularly in Spain and Portugal, that are being structured as public or private securitisations. In the case of Spain and Portugal, these transactions are structured under the relevant securitisation laws using, in Spain, a securitisation fund vehicle known as an "FT" or, in Portugal, a credit securitization company known as an "STC", both of which benefit from the principle of statutory segregation pursuant to the national legislation under which they are established. As many of these portfolios comprise a significant number of REO assets rather than loans, the advantage of employing such a securitisation structure and relying on the statutory segregation is that it avoids the need to take security over the REO assets and the payment of stamp duty on the creation of such security. In addition, in the Spanish market, a number of transactions have been structured using a joint venture structure, where the seller contributes the NPL and REO assets to a newly incorporated subsidiary, with typically 80% of the share capital of the new subsidiary being sold to the third-party buyer. Again, this avoids the need to pay stamp duty unlike a sale and transfer of the NPLs and REOs as an asset transfer.

As new NPL markets across Europe become more active, it is to be expected that the sponsors and the financiers who have been active in recent years will be the ones leading the charge into new markets, taking the techniques and structures developed in more mature markets and adapting them to take account of the jurisdiction-specific issues

3 Law 5/2019 of 15 March, regulating real estate credit agreements and implementing the provisions of Directive 2014/17 in Spain.

in new markets. We will now turn to a discussion of some of the key themes in an NPL transaction and how these may be approached, both in mature and newer NPL markets.

While there is no one-size-fits-all approach to NPL sale and purchase agreements in the more mature NPL jurisdictions, there are certainly common approaches taken by many vendors of NPL portfolios. The market has in recent years, remained a buyer-beware market, both for non-performing commercial real estate loans as well as more granular portfolios of residential mortgages and other consumer assets. There is no reason to suggest this will change as sponsors move to invest more in markets such as Greece. Vendors may be expected to offer little to no comfort by way of representations and warranties on the portfolios they bring to market. Where vendors do offer representation and warranty coverage on the assets, this is likely to be subject to a fairly short sunset period, caps on overall liability as well as de minimis thresholds before claims can be brought.

Given the lack of representation and warranty coverage, the due diligence review becomes even more important to buyers and their lenders given that their recourse truly is limited to the NPL assets acquired and financed. If it transpires that there is an issue with the assets acquired – particularly if this turns out to be systemic across the portfolio – the absence of representation and warranty coverage means it will first be the sponsor and, if sufficiently serious, the senior debt providers, who are economically exposed to this risk.

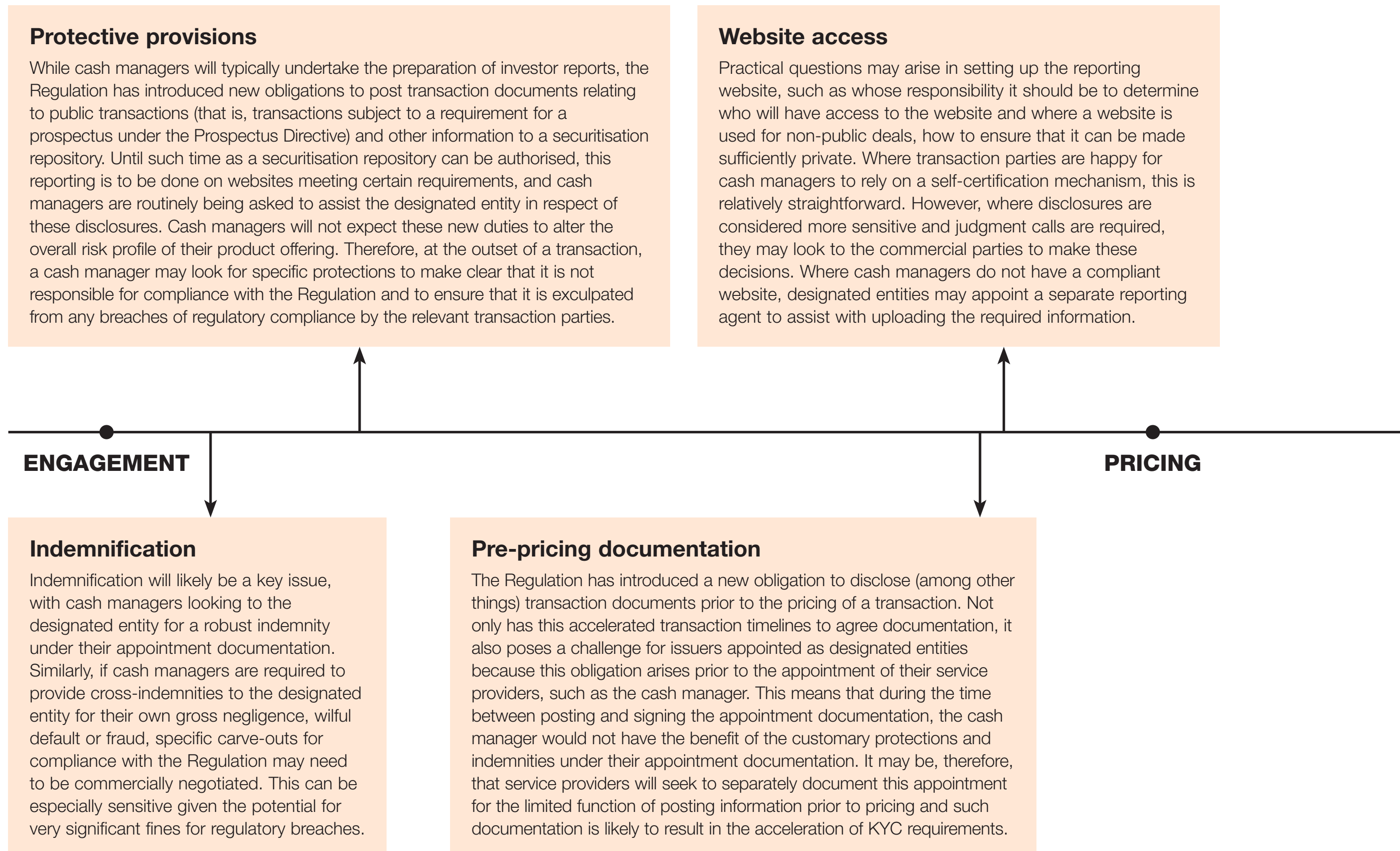
Given that nearly all NPL financings are limited recourse to the assets constituting the portfolio, the lenders must have regard to the nature of each individual portfolio and its characteristics in putting together a senior debt package. It will, of course, be helpful that there is clearly an alignment of interests between the lenders and the sponsor as they are both entirely economically dependent on the sponsor performing in line with its business plan projections, but this does not remove the need for senior lenders to have a seat at the table early enough to right the ship should things start to go awry. While common themes have developed across the NPL markets in respect of the debt packages available to sponsors, they key consideration for lenders remains striking the right balance between allowing equity leakage and allocating risk away from the senior debt. Much of the negotiation in NPL financings continues to be around the waterfall and cash sweeps, which are typically based on loan-to-recoverable value and loan-to-purchase price tests; this will continue to be the case in both mature NPL markets and in new jurisdictions.

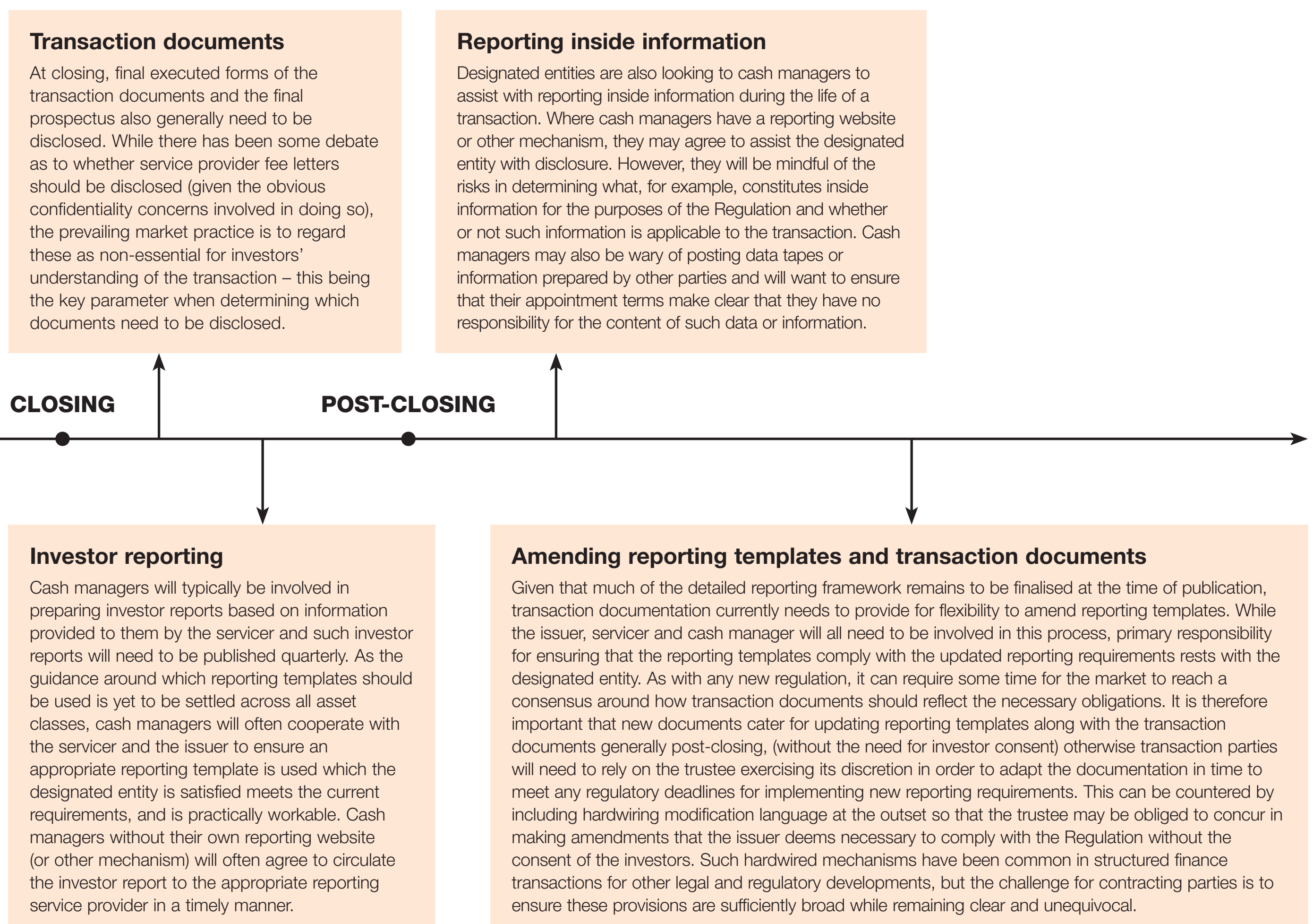
SECURITISATION REGULATION: NEW RISKS AND REWARDS FOR CASH MANAGERS AND NEW 'DISCRETION' FOR CORPORATE TRUSTEES?

The responsibility for compliance with the Securitisation Regulation (the "**Regulation**") on a given transaction ultimately lies with the entities under direct regulatory obligations – broadly the originator, sponsor, issuer and investors. In respect specifically of the transparency obligations under Article 7 of the Regulation, the practical day-to-day responsibility will often be given to the issuer as the "designated entity" under Article 7(2). This means it is something of a central hub for ensuring reporting under Article 7 is done in accordance with regulatory requirements. Particularly where a special purpose issuer is appointed to this role, it will often require assistance in carrying out these reporting duties from third parties – normally because it lacks the expertise or operational capability to perform these functions. Cash managers are often well-placed to provide such reporting services and, in the absence of an authorised securitisation repository, they may also be well-placed to assist the issuer in complying with the website publication requirements designed to ensure Article 7 reporting is accessible to the parties entitled to receive it.

All of this gives rise to a number of issues that cash managers and trustees will want to bear in mind when appointed on transactions affected by the Regulation. These include risk issues for these service providers around reporting and documentary amendments which we consider in more detail below.

Timeline of a transaction




Transaction documents
At closing, final executed forms of the transaction documents and the final prospectus also generally need to be disclosed. While there has been some debate as to whether service provider fee letters should be disclosed (given the obvious confidentiality concerns involved in doing so), the prevailing market practice is to regard these as non-essential for investors' understanding of the transaction – this being the key parameter when determining which documents need to be disclosed.
Reporting inside information
Designated entities are also looking to cash managers to assist with reporting inside information during the life of a transaction. Where cash managers have a reporting website or other mechanism, they may agree to assist the designated entity with disclosure. However, they will be mindful of the risks in determining what, for example, constitutes inside information for the purposes of the Regulation and whether or not such information is applicable to the transaction. Cash managers may also be wary of posting data tapes or information prepared by other parties and will want to ensure that their appointment terms make clear that they have no responsibility for the content of such data or information.
CLOSING
POST-CLOSING
Investor reporting
Cash managers will typically be involved in preparing investor reports based on information provided to them by the servicer and such investor reports will need to be published quarterly. As the guidance around which reporting templates should be used is yet to be settled across all asset classes, cash managers will often cooperate with the servicer and the issuer to ensure an appropriate reporting template is used which the designated entity is satisfied meets the current requirements, and is practically workable. Cash managers without their own reporting website (or other mechanism) will often agree to circulate the investor report to the appropriate reporting service provider in a timely manner.
Amending reporting templates and transaction documents
Given that much of the detailed reporting framework remains to be finalised at the time of publication, transaction documentation currently needs to provide for flexibility to amend reporting templates. While the issuer, servicer and cash manager will all need to be involved in this process, primary responsibility for ensuring that the reporting templates comply with the updated reporting requirements rests with the designated entity. As with any new regulation, it can require some time for the market to reach a consensus around how transaction documents should reflect the necessary obligations. It is therefore important that new documents cater for updating reporting templates along with the transaction documents generally post-closing, (without the need for investor consent) otherwise transaction parties will need to rely on the trustee exercising its discretion in order to adapt the documentation in time to meet any regulatory deadlines for implementing new reporting requirements. This can be countered by including hardwiring modification language at the outset so that the trustee may be obliged to concur in making amendments that the issuer deems necessary to comply with the Regulation without the consent of the investors. Such hardwired mechanisms have been common in structured finance transactions for other legal and regulatory developments, but the challenge for contracting parties is to ensure these provisions are sufficiently broad while remaining clear and unequivocal.

THE ANTI TAX AVOIDANCE DIRECTIVE: IMPACT ON STRUCTURED DEBT

In 2013 the Organisation for Economic Cooperation and Development ("**OECD**") and G20 launched a project to address "base erosion and profit shifting" ("**BEPS**"). In short, the project seeks to deal with tax planning strategies that shift profits from high tax to low tax, or no-tax jurisdictions. The project is divided into fifteen "Actions" covering a range of issues that include the digital economy (Action 1), hybrid structures (Action 2), controlled foreign companies (Action 3), interest deductions (Action 4) and treaty abuse (Action 6). The OECD published final reports on each "Action" on 5 October 2015, which set out recommendations for governments on how to tackle the abusive behaviours identified. In this article we consider the recommendations of two "Actions" (as enacted in the EU) that we are encountering most frequently in the context of structured debt transactions – namely the interest restriction rule (the so-called "**interest barrier rule**") and the anti-hybrid rules.

As part of its own efforts to combat tax avoidance practices, the EU agreed to implement certain of the OECD's recommendations through the Anti Tax Avoidance Directive ("**ATAD**"). The first ATAD ("**ATAD I**") was passed on 13 July 2016 and addressed areas including interest deductions, controlled foreign companies and hybrid mismatch structures (i.e. financial instruments and entities that are treated in one way for tax purposes by one jurisdiction and in a different way by another jurisdiction) within or among EU Member States. The second ATAD ("**ATAD II**") was passed on 29 May 2017 and addressed hybrid mismatch structures involving EU Member States and other jurisdictions and other more complex hybrid mismatch structures. It is up to each EU Member State to implement ATAD into its local law and Member States are at different stages of that process. It is possible that some Member States will adhere quite closely to the drafting of ATAD, while others might deviate substantially. It is also open to different Member States to have different interpretations of the rules. Further, even within ATAD there are options for Member States, for example, each can choose whether or not to adopt certain exemptions. We are therefore in an uncertain environment with respect to how ATAD might impact structured debt transactions.

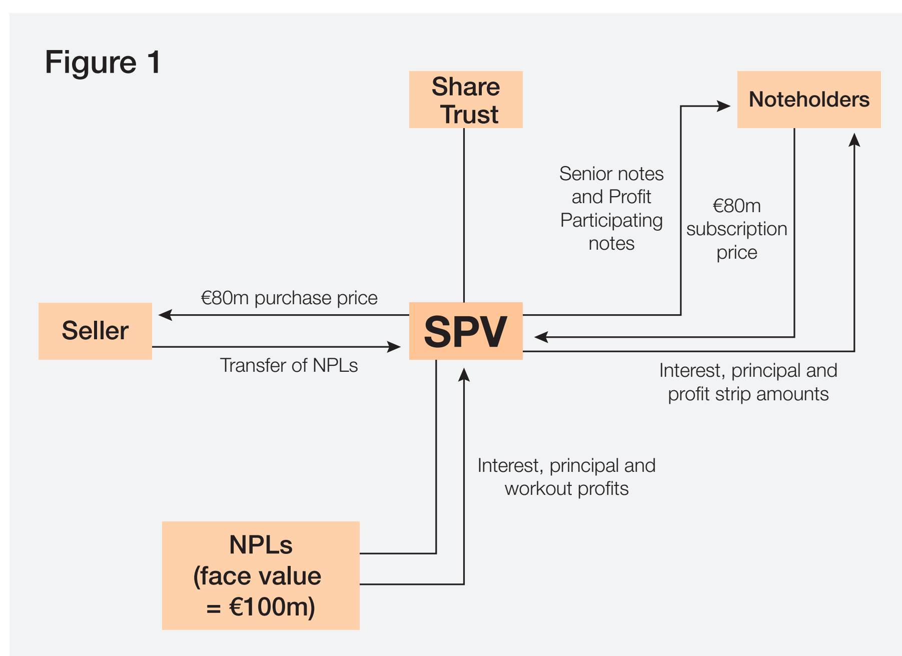
Interest barrier rule

The interest barrier rule applies to limit interest deductions for tax purposes. ATAD I sets out that it should apply from 1 January 2019. Under the rule, a taxpayer is permitted to deduct "exceeding borrowing costs" up to the higher of 30% of taxable EBITDA and a *de minimis* amount of up to EUR 3 million (noting that The Netherlands and Spain, for example, have opted for EUR 1 million) in any one tax period. For the purposes of ATAD, "exceeding borrowing costs" is defined as the amount by which the deductible "borrowing costs" (i.e. interest and other expenses of borrowing) of a taxpayer exceed the amount of its taxable interest revenues and other economically equivalent taxable revenues. Obviously, where interest income exceeds interest deductions, the interest barrier rule will not present a problem. Where it is more likely to be an issue is in transactions where an entity makes interest payments but receives income which is not economically equivalent to interest or is just not interest (such as rental income).

The term "borrowing costs" is defined broadly and includes expenses on all forms of debt, other costs "economically equivalent to interest" and expenses incurred in connection with the raising of finance. However, "taxable interest revenues and other economically equivalent taxable revenues" is not defined. One logical interpretation might be to mirror the definition of borrowing costs – i.e. if a liability is considered a borrowing cost for a debtor an equivalent asset should be interest income for a creditor. However, this depends on the implementation of ATAD and it is not certain how Member States will define or interpret "interest revenues" or "equivalent" amounts, which creates some uncertainty as to the application of the interest barrier rule.

One particular area of concern is how the interest barrier rule might affect the securitisation of non-performing loans. For example, an orphan SPV (see figure 1) acquires a portfolio of NPLs with a face value of EUR 100 million for consideration

of EUR 80 million. It issues senior notes and profit participating notes to fund the purchase price. Any profit realised on the portfolio from working out the NPLs will be paid out to the holder of the profit participating notes. The question is whether the amounts realised over and above the EUR 80 million of purchase price are regarded as "interest revenues" for the purposes of the interest barrier rule. It may be that the disposal or repayment of NPLs gives rise to a capital gain or that enforcement of any real estate security gives rise to taxable income. To the extent that amounts in excess of the EUR 80 million of discounted purchase price are not "interest revenues" or "equivalent" amounts, then there would be "exceeding borrowing costs" and their deductibility for tax purposes will be restricted up to 30% of taxable EBITDA (subject to the application of the *de minimis* exemption). This would create a higher tax charge in the SPV.



Of course, the result may be different where an SPV purchases a pool of performing loans at a discount that simply reflects the delay in collection. In this case, the amounts received by the SPV in excess of the discounted purchase price would (in our view) be more likely to be regarded as income "equivalent" to interest. However, different jurisdictions will have different interpretations of what is "equivalent" to interest and the application of the interest barrier rule will need to be considered on a deal by deal basis.

Importantly, ATAD I also gives Member States the option to implement various exemptions from the interest barrier rule. ATAD I contains an option to exempt "standalone" entities. However, it will be difficult in practice for many standard orphan SPVs to fall within this definition as a standalone entity does not include one that is consolidated for financial accounting purposes or one that is "associated" with another entity (where "associated" is defined broadly). ATAD I also gives Member States the option to exempt certain financial institutions from the rules – including collective investment vehicles, insurance undertakings and pension schemes. In Luxembourg, this exemption has been implemented to include securitisation companies that are subject to the Securitisation Regulation. However, it must be considered carefully whether qualifying as a "regulated securitisation company" is a desirable outcome when taken in the round, given the sometimes onerous requirements of the Securitisation Regulation. There may also be some tension between the preference of the junior noteholders, who want the most efficient and most certain tax outcome, and that of the senior noteholders, who may find holding securitisation notes unattractive for a variety of reasons, including (in the case of banks and insurance companies) the associated capital costs and (in the case of funds) restrictions placed on them by investors.

Anti-hybrid rules

The anti-hybrid rules are designed to neutralise the effect of "mismatch outcomes" that arise as a result of hybrid financial instruments and hybrid entities. There are two "mismatch outcomes". A "deduction without inclusion" outcome arises, broadly, where a deduction taken by a payer in respect of a payment is not matched by a corresponding taxable receipt in the hands of a payee. For example, an issuer gets the benefit of a tax deduction in respect of an interest payment on a bond but the payment is not subject to tax in the hands of the bondholder. In this case, the rules provide that the primary response should be to deny a deduction for the payer and, where that is not the case (for example, because anti-hybrid rules have not been implemented in the relevant jurisdiction), the secondary response should be to impute taxable income to the payee.

A "double deduction" outcome arises to the extent that two entities benefit from a deduction for tax purposes with respect to the same payment. For example, the entity making a payment is a hybrid entity (e.g. is treated as taxable by the entity's jurisdiction, but tax transparent by jurisdiction of its investors), which could mean that the investor in the entity gets the benefit of a deduction for tax purposes as does the payer entity itself. In this case, the rules provide that the primary response should be to deny a deduction for the investor and the secondary response should be to deny a deduction to the payer entity.

These rules apply mainly[1] where the payee and payer, or payer/payee and investor are "associated enterprises", which is very broadly defined in ATAD II. In the case of a mismatch outcome arising as a result of a hybrid financial instrument, two entities (i.e. the payer and payee) are "associated" if one holds a 25% or more participation in terms of voting rights or capital ownership in the other or is entitled to receive 25% or more of its profits. Two entities are also "associated" where they are part of the same consolidated group for financial accounting purposes or where one entity has significant influence in the management of the other. In addition, there are "acting together" rules, where the voting rights or capital ownership of one entity can be attributed to another. In the case of a mismatch outcome arising as a result of a hybrid entity (as opposed to a hybrid financial instrument), the threshold for association is increased to 50%, rather than 25%.

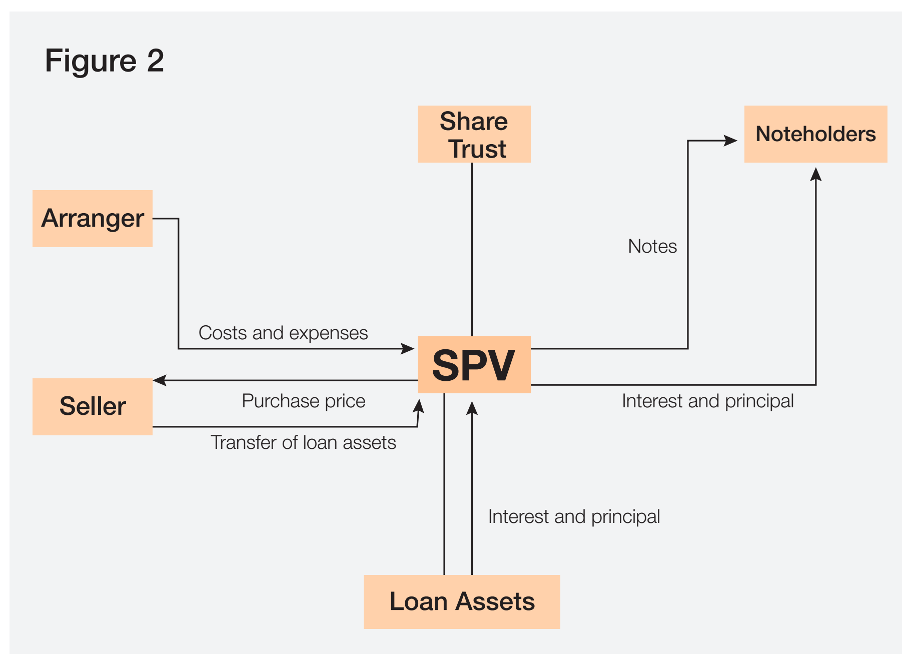
ATAD I sets out that the anti-hybrid rules should apply with respect to hybrid mismatch outcomes arising between entities all of whom are in Member States from 1 January 2019. ATAD II extends those rules so they apply to to hybrid mismatch outcomes between entities in Member States and other jurisdictions from 1 January 2020.

Therefore, in the context of structured debt transactions, where financial instruments will necessarily feature, an entity making payment will need to consider two key issues, neither of which will necessarily have a straightforward answer:

1. What is the tax treatment of the payment in the hands of the recipient?
2. Is the payer entity "associated" with the recipient of the payment?

In respect of the first issue, how much investigation into the tax position of the recipient must the payer undertake in order to reach a filing position? This is not clear on the face of ATAD, and different jurisdictions may take different approaches. A problem could arise, for example, in the context of listed and traded notes where it would be very difficult to obtain sufficient information about the identity of the recipients of payments, much less how how they are taxed. In respect of the second issue, the test is easily applied where entities are connected by share capital or consolidation, but there is uncertainty as to how "entitlement to profits" and "significant influence" should be interpreted. Further, the "acting together" rules could deem investors in transparent collective investment vehicles to have the rights of the other investors, such that each investor would be "associated" with, for example, a debtor under a financial instrument held by the collective investment vehicle without even knowing it.

One area in which we have seen uncertainty around the anti-hybrid rules presenting problems is in repackaging transactions. For example, an orphan SPV purchases loan assets using proceeds raised from issuing a single



1 They also apply where the payment is part of a "structured arrangement", but this is unlikely to be a concern in most structured debt transactions. For these purposes, a structured arrangement arises where, viewed objectively (i.e. irrespective of the intention of the parties), the structure was designed to achieve the mismatch outcome.

class of debt instruments (see figure 2). The arranger is funding the costs and profits of the SPV, so this is a "passthrough" deal. The SPV claims deductions for interest paid on the notes, but in some jurisdictions the notes could be considered to be equity (because the SPV has nominal legal equity) and so interest payments may not be taxed in the hands of the noteholders. It is therefore possible that a "deduction without inclusion" outcome arises in respect of payments on the notes. However, the anti-hybrid rules will only apply if the SPV and the noteholder are "associated enterprises"[2]. The question is whether, in this sort of deal, the noteholder is considered to have an "entitlement" to profits at a level sufficient to mean it is "associated" with the SPV. This very much depends on whether a particular jurisdiction adopts a narrow or broad interpretation of "entitlement to profits" and this is currently a grey area in many Member States. This is a particularly live issue in the case of notes that are traded on a stock exchange, as the SPV will have no control over the holders of the notes and no knowledge of how they are taxed.

Conclusion

ATAD is introducing significant changes to the tax treatment of interest payments and there is currently uncertainty as to the extent of the impact of those changes on structured debt deals. Furthermore, the position may be different depending on how the rules are adopted in any given Member State. It is therefore important that the implications of the interest barrier rule and the anti-hybrid rules are considered carefully when structuring transactions and any impact on historic transactions is assessed.

2 Assuming no "structured arrangement" as discussed in the previous footnote.

PD3 AND SECURITISATION PROSPECTUSES: RENOVATION OR NEW BUILD?

Will the new EU regime embellish current prospectus requirements or re-craft them entirely? Securitisation practitioners may be concerned that the European Commission's decision to replace the EU Prospectus Directive regime entirely might result in significant change. In fact, they will find much that is familiar in the new PD3 regime. This article outlines the new landscape, highlights key similarities and differences and provides some tips to smooth the transition.

When do you need an approved prospectus for offers of securities to the public in the EEA or for admission to trading on an EEA regulated market? If so, what disclosure must it contain? Since 2005, those questions have been mandated by Directive 2003/71/EC, as amended, and underlying legislation, referred to as the EU Prospectus Directive ("**PD**") regime. On 21 July 2019, however, the PD regime will be repealed in full. It will be replaced by a new regime commonly referred to as "PD3" – Regulation (EU) 2017/1129 and subsidiary legislation – one of the EU Capital Markets Union ("**CMU**") initiatives and a regulation with direct effect in EU Member States.

PD3: impact on securitisation prospectuses

Context is everything – PD3 is a piece of legislation relating to securities offerings generally, so many of its provisions are not written with securitisation specifically in mind. Indeed, even the provisions that might initially appear to be specifically about securitisation (all those tagged for "asset-backed securities") won't necessarily make sense for securitisation. This is because the term "asset-backed security" as it is used in the context of PD3 covers a wide range of securities, including a number of retail structured products, for example, that are not securitisations.

There is good news, however. For those who have been grappling with the intricacies of the Securitisation Regulation (another CMU initiative) over the last few months, the advent of PD3 in late July may be seem like a drop in the ocean. Some preliminary good news about PD3 when it comes to securitisation prospectuses is as follows:

- **Some grandfathering will be available:**
  - The recent ESMA Q&A on PD3 published on 29 March 2019 confirmed that an issuer may continue to use a programme base prospectus approved prior to 21 July 2019 (that is, under Directive 2003/71/EC, as amended and associated legislation) for the remainder of its 12-month life. Furthermore, issuers will also be able to supplement that prospectus, if necessary, by reference to current PD disclosure requirements instead of the new PD3 disclosure requirements.
  - This will only be of use to those with programmes, rather than stand-alone prospectuses, and does not extend to registration statements. The grandfathering will, nonetheless, be helpful for those with programmes wishing to avoid being the first to have to address the new regime on 21 July 2019.
  - Some parties are bringing forward the approval of base prospectuses ahead of 21 July 2019, in order to take advantage of the available grandfathering.
- **Wholesale denominations will mean lighter disclosure:**
  - Securitisation transactions tend to have high denominations of Euro 100,000 (or equivalent) and above, commonly referred to as "wholesale".
  - "PD3-compliant" prospectuses after 21 July will therefore mostly benefit from one of the key successes resulting from industry lobbying during the PD3 legislative process – namely, the retention of the current distinction between "wholesale" and "retail" securities and prospectuses.
  - The wholesale "offer to the public" exemption continues to be available, meaning that a prospectus will only be required for the purposes of admitting to trading on an EEA regulated market. Moreover, wholesale prospectuses, if required, benefit from lighter disclosure, do not require a prospectus summary and will not be required to adopt a "plain language" format (one of the new retail requirements under PD3).
  - As a new development, "wholesale"-style disclosure may also be adopted for securities with lower denominations provided that they are admitted to trading on a segment of a market only accessible by qualified investors and

provided that secondary sales will be limited to qualified investors – a useful development in the context of Article 3 of the Securitisation Regulation regulating offers of securitisations to retail investors.

- **Omnibus 3 proposals for centralising approvals have gone:**
  - Looking further ahead, the contentious proposals to amend PD3 and, in due course, to centralise certain prospectus approvals under ESMA – including those for asset-backed securities – have been dropped and no longer appear in the draft Omnibus 3 text adopted in the European Parliament on 16 April 2019.

Disclosure: some key differences for securitisation prospectuses post-21 July 2019

The prospectus disclosure requirements derive from a mixture of the level 1 Regulation (EU) 2017/1129, which is in final form, and underlying legislation, which is in "near-final" form. As with the current PD regime, the bulk of the detailed prospectus disclosure requirements are contained in a series of disclosure Annexes in the level 2 legislation.

The draft level 2 disclosure Annexes for the PD3 regime were published by the European Commission in mid-March. While, technically, they are still in an "objection period" where the European Parliament or Council may comment, significant changes seem unlikely at this stage.

The relevant Annexes for asset-backed securities in the draft level 2 measures are Annexes 9 and 19: one relates to the registration document; the other to the securities note. Helpfully for practitioners, there is significant overlap between the PD3 Annexes and current PD disclosure requirements. There will, however, be some changes required to prospectus disclosure after 21 July 2019. A few elements from the two draft PD3 Asset-backed Annexes are highlighted below:

- **Risk factors:** While not unique to securitisation, the new obligation to group risk factors in categories, with, in each category, the most material risks set out first, is likely to be an area of significant debate for prospectuses after 21 July 2019. Similarly, although there is no absolute limit on the number of categories or of risk factors, this is likely to be a point of discussion with competent authorities – and also the requirement for "specificity" and for "corroboration" of risk factors in the prospectus content. ESMA has prepared a guidance paper with 12 guidelines for competent authorities, to assist them in reviewing risk factors. The ESMA guidance will also be useful for parties drafting prospectuses, but the new risk factor requirements may well be a reason to try to avoid being one of the first few issuers immediately after 21 July 2019.
- **STS and risk retention:** Some Securitisation Regulation concepts are reflected in the disclosure Annexes. The Annexes for asset-backed securities now require information regarding simple, transparent and standardised securitisation (STS) compliance and also mandate disclosure of the applicability of the risk retention requirements and the nature of the material net economic interest retained by the originator, sponsor or original lender.
- **Underlying assets:** Broadly speaking, disclosure on the issuer and on the underlying assets is substantially the same as it was under the old regime, but there are a few slight changes to mandated disclosure, which will mostly affect non-securitisation ABS. One is that, where principal is not at risk, more limited disclosure on the underlying is specified, with only the name of the issuer of the reference asset, the ISIN and an indication about where information about performance may be obtained is required. Similarly, where underlying assets are on a regulated market or third country equivalent, more limited information can be given. For asset-backed securities referencing an index, additional disclosure in line with elements of the "*securities giving rise to payment or delivery obligations linked to an underlying asset*" (Annex 17) will be required.
- **Electronic access:** Securitisations are also caught by the focus on making information available to investors electronically. If an issuer has a website, it must be mentioned, along with a disclaimer about content of the website not forming part of the prospectus. There are similar requirements for guarantors and third parties. In addition, "documents available" are no longer to be available in physical form, but, rather, on a website (although the Annex does not say that this must be the issuer's website, so there seems to be no need for SPVs to set up websites specifically for this purpose).
- **Financial information:** The asset-backed Annexes carry over the distinction between financial disclosure for wholesale and retail disclosure. A new requirement is to set out in full any modifications, qualifications or refusals by statutory auditors.
- **Advertisements:** Under PD3, an advertisement is newly defined as any "communication" provided it is "(i) relating to a specific offer of securities to the public or to an admission to trading on a regulated market" and "(ii) aiming to specifically promote the potential subscription or acquisition of securities". Although not specific to securitisation, the fact that an advertisement under the new PD3

regime is simply a "communication" – and that ESMA has indicated that bilateral conversations might well be caught – means that parties will be giving some focus to whether both limbs of the definition are satisfied. Given that securitisations are likely to be wholesale and targeted at professional investors, the more detailed advertisement disclosure required for retail investors (such as a requirement for a statement that the advertisement should not be understood as an endorsement of the securities and also, potentially, a "comprehension alert" for complex securities) is unlikely to be relevant. Instead, when dealing with qualified investors, merely a link to the prospectus or details where the prospectus will be published will suffice. The existing requirements that advertisements must not contradict a prospectus and must be supplemented if content becomes misleading are, however, carried over into PD3. In view of the new reference to a "communication" and potential broader scope, industry bodies such as AFME and ICMA are coordinating with their members to try to reach a consensus, ahead of 21 July 2019, about which transaction announcements fall within scope. It is, though, worth noting that the new advertisement regime will also apply in respect of grandfathered prospectuses after 21 July 2019.

- **Categories:** It is also worth noting that the location of the disclosure of some items has been amended by altering the categorisation of certain items in the securities note Annex. Categories determine whether disclosure must go in the base prospectus or can be completed on issue (see box immediately below).

"Category A" information must be included in the base prospectus.

"Category B information must be included in the base prospectus except for details of that information that are not known at the time of approval of that base prospectus and which shall be inserted in the final terms.

"Category C" may be inserted in the final terms (unless known at the time of approval of the base prospectus, in which case it may be inserted in that base prospectus instead).

Legislation creating the new PD3 regime

Level 1 – Framework principles

- The remainder of Regulation (EU) 2017/1129 (commonly referred to as "PD3") takes effect on 21 July 2019. It will repeal Directive 2003/71/EC, as amended (the "PD") in full.

Level 2 – Commission technical implementing measures

- A draft Commission Delegated Regulation, with Level 2 requirements (such as, prospectus content), was published by the European Commission on 14 March 2019. It will repeal the current Level 2 Regulation 809/2004/EC (on information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements) in full.
- A draft Commission Delegated Regulation with Regulatory Technical Standards for key financial information in the summary of a prospectus, data and machine readability of prospectuses, advertisements, prospectus supplements and prospectus publication was published by the European Commission on 14 March 2019. It will repeal both Delegated Regulation 382/2014 (on prospectus supplements) and Delegated Regulation 2016/301 (on approval and publication of the prospectus and dissemination of advertisements).
- Both drafts are subject to objection periods.

Level 3 – Guidelines, etc.

- ESMA Final Report on Guidelines to competent authorities on risk factors was published on 29 March 2019.
- ESMA Final Report on Technical advice on Minimum Information Content for Prospectus Exemption was published on 29 March 2019. This relates to mergers, divisions or takeovers and third country equivalence.
- ESMA Q&A on PD3 were published on 27 March 2019. These are fairly limited in scope and mainly focus on grandfathering and transition. The current ESMA Q&A on the PD are due to be revised in due course to reflect PD3 requirements but are not yet available.

Certain items in the asset-backed Annex have moved to become "C" and able to be included in Final Terms (such as the general description of each obligor in a small number of easily identifiable obligors (item, 2.2.2 - previously, "Category A")). Conversely, others have become "Category A" or "Category B", such as: disclosure of the loan to value level of collateralisation (item 2.2.6 - previously "C" and now "B"), the parameters within which investments can be made (item 2.3.2 – previously, "B" and now "A"), the explanation of the flow of funds (item 3.4 - previously "B" and now split into two limbs of "A" and "C"), and how payments are collected in respect of the assets (item 3.4.6 – previously "B" and now "A").

To assist our clients with preparations for 21 July 2019, Clifford Chance has prepared blackline comparisons of the asset-backed Annexes (namely, Annexes 9 and 19), showing changes from the PD Annex requirements (Annexes VII and VIII). Speak to your usual Clifford Chance contact to obtain copies.

PD3 – High level overview

Broadly speaking, the PD3 regime retains a number of familiar concepts from the current PD regime, notably:

- retaining a distinction between disclosure required for "wholesale" (high denomination) debt and "retail" (low denomination) debt. The "wholesale" disclosure will also be available for bonds admitted to trading on a restricted "professionals only" market or segment and no resale to non-qualified investors.
- retaining the concept of passporting, enabling a prospectus approved by one "Home Member State" to be used in another Member State without any changes and subject to a few formalities.
- limiting scope to EEA regulated market admission (rather than extending the regime to MTFs, as initially mooted).
- retaining similar public offer exemptions.
- for base prospectuses, continuing the concept of Category A, Category B and Category C disclosure.

New PD3 features include:

- a universal registration document (URD) – a "live" document intended to facilitate issuance (although requiring "equity" disclosure, irrespective of product).
- a more limited secondary disclosure regime for fungible deals.
- new, but less prescriptive prospectus summary requirements.
- limiting summaries for base prospectuses to issue-specific summaries.
- a new requirement for risk factors to be in categories, with the most material risk factors in each category placed first.
- "advertisement" now a "communication", so likely to be construed more broadly.

AN EU COVERED BOND FRAMEWORK: CHANGE FOR CHANGE'S SAKE OR TIME TO TAKE COVER?

In March 2018, as part of the Capital Markets Union project, the European Commission announced its proposal for an integrated framework for covered bonds. Reactions to the proposal have been mixed from players in the European covered bond markets, with concerns raised as to the possible interference in already established and well-functioning domestic markets and the creation of a two-tier standard for covered bonds. In this article, we examine the main objectives for this governance package and how they might affect existing and future market participants.

The existing landscape

Covered bonds are debt obligations issued by credit institutions and secured against a ring-fenced pool of assets to which bondholders have direct recourse as preferred creditors while remaining entitled to claim against the issuing entity as an ordinary creditor. This 'dual recourse' feature is fundamental to the architecture of a covered bond.

Historically, covered bonds have benefited from favourable regulatory treatment at the EU level – especially as compared to securitisations – but without there being any meaningful EU-level framework for what constitutes a covered bond. Instead, the EU preferential treatment has been patchy, with reference often had to a provision in the UCITS Directive but with various other requirements added on for specific purposes.

The covered bond market is well-established and, while issuance volumes have slowly fallen in recent years, outstanding volumes reached nearly EUR 2.5 trillion in 2017. Covered bonds gained popularity particularly through the global credit crisis and are now increasingly viewed by fund managers as being an attractive alternative to government bonds.

That said, covered bond markets in the EU remain largely fragmented along national borders. Participation, and indeed performance, varies greatly from Member State to Member State. Some argue that this fragmentation is necessary because national markets have developed based on local insolvency- and asset-linked legal factors. The EU Commission's proposal, however, was based on the wider CMU idea that national fragmentation constrains standardisation in underwriting and disclosure practices and creates obstacles to deep, liquid and accessible markets, particularly cross-border markets. The proposal also aims to address the fact that the current patchwork of covered bond regimes leaves markets in certain Member States underdeveloped.

In order to enhance the use of covered bonds as a stable and cost-effective source of funding for credit institutions, the proposed EU-level framework sets out a number of key governance proposals. Before we examine these proposals in more detail, we should highlight that concerns were expressed at consultation stage about interference in familiar and established domestic markets. In response, the Commission has approached its legislative task by attempting to create a framework to ensure that national regimes comply with certain principles-based minimum harmonisation requirements rather than by trying to create a one-size-fits-all regime, thereby allowing national divergence in key areas to remain. This approach should be welcomed.

A new definition

As mentioned above, there has not historically been a central or complete definition of what constitutes a covered bond at the EU level. The new framework seeks to provide such a definition, laying out the minimum structural requirements, including dual-recourse and bankruptcy-remote features. It is suggested that by introducing a commonly agreed definition, harmonisation would be achieved. To date, preferential treatment has been applied equally to instruments that differ in nature as a result of differing national regimes, leading to greater risk for investors.

Quality of the cover pool

One of the cornerstones of the new framework is laying down provisions to ensure the quality of the cover pool, including provisions related to the segregation and location of cover assets, the level of homogeneity of assets and ensuring that assets located outside of the EU are of the same quality as those in the EU. In particular, high quality assets

are characterised as having specific features making them eligible to cover the claims attached to the covered bonds. While the proposal sets out a prescriptive list of what it considers to be 'high-quality' assets[1], flexibility is provided for Member States to allow additional categories of assets or exclude certain assets within their national framework. Where a cover pool monitor is required to perform a supervisory role under the relevant national regime, the EU framework seeks to standardise the minimum supervisory requirements for this role.

Pooled and joint funding structures

One of the key concerns for the EU when developing the new framework was to deepen liquidity in the covered bond markets and facilitate market access for smaller institutions and for jurisdictions which do not yet have an established domestic framework. The new framework therefore allows for the pooling of assets by two or more credit institutions belonging to a group through internally-issued covered bonds which provide collateral for a public issuance of covered bonds. Alternatively, loans granted by a credit institution and collateralised by residential or commercial property, mortgages, liens and other security rights are permitted to be used as assets for the cover pool for the issue of covered bonds by another credit institution. In each case the structures are subject to the segregation of assets and other principles enshrined in the framework.

Liquidity buffer

Of particular note is the introduction of a liquidity buffer calculated on covered bond net liquidity outflows over a period of 180 calendar days, which can be held in a range of liquid assets. Net outflows are defined as all principal and interest payments of the covered bonds and cashflows on derivatives after considering expected inflows over the same period. The assets should be recorded at market value and are subject to haircuts. They should be held in either a segregated account or subject to credit safeguards. Concerns were raised at the consultation phase of double-counting between this new buffer and the liquidity coverage requirement more generally applicable to EU banks. It seems that, in response to those concerns, the proposed Directive will provide Member States with discretion to take account of other liquidity requirements and determine if the liquidity buffer should only apply where there are insufficient other liquidity requirements imposed on the relevant issuer.

Transparency requirements

Unsurprisingly given the current regulatory landscape, the new framework puts additional emphasis on transparency and ensuring that investors are provided with sufficient information to evaluate the profile and risks of a particular programme in order to support their due diligence efforts. The framework requires a minimum standard of quarterly reporting, requiring portfolio information on an aggregated basis, but leaves the door open to Member States to elect to also require reporting on a loan-by-loan basis. Such investor reporting requirements are more extensive than those typically required in existing covered bond regimes and therefore issuers will need to prepare themselves for an enhanced reporting environment. For those that are familiar with the evolving reporting obligations under the Securitisation Regulation, this will not necessarily be too concerning. However, for smaller institutions or others not accustomed to securitisation-style transparency requirements (and depending on how the transparency requirements are translated under each domestic regime) this may be more problematic. Even for those accustomed to detailed loan-by-loan reporting, there is the potential for additional burdens if standards are not harmonised.

Extendable maturity structures

The proposed Directive would impose certain limitations on the issue of covered bonds with extendable maturities. The most notable of these is that the extension could not be triggered at the discretion of the issuer. Conditional pass-through and soft bullet structures have become the norm in existing programmes and there is some uncertainty as to whether these structures would fall foul of the limitations outlined in the proposed EU framework. Arguably these structures have developed to protect investors, for example to maximise recoveries by avoiding fire sales, and therefore it might be difficult to see why such structures should be excluded from preferential regulatory treatment, provided that the triggers for any extension of maturity are appropriately certain and disclosed to investors.

'European Covered Bonds' label

The proposed framework provides for a new 'European Covered Bond' label to be available to programmes which meet the minimum requirements laid out by the proposed frameworks. Many will already be familiar with the ECBC Covered Bond Label initiative. The Commission made it clear that this new label should apply in

1 The proposal cross-refers to paragraphs (a) to (g) of Article 129(1) of Regulation (EU) No. 575/2013.

parallel to existing labelling frameworks. However, it is yet to be considered what the cost and administrative burden of obtaining and maintaining the label will look like.

Amendments to the Capital Requirements Regulation

As part of the proposed framework, an amending regulation to the Capital Requirements Regulation ("**CRR**") is proposed which is intended to better align the prudential treatment of covered bonds under the CRR. In essence, the proposal is to tighten up the requirements under Article 129 of the CRR to ensure that covered bonds that meet the criteria are of uniform quality. Of note is a minimum overcollateralisation level of 5 per cent.

Next steps

So, what happens next? The final text of the Directive was provisionally approved by the European Parliament on 18 April 2019. The Directive requires Member States to adopt implementing laws and regulations no later than 18 months following its publication in the Official Journal and such implementing laws must enter into force no later than 12 months from such date. The Regulation will be directly applicable 20 days following publication in the Official Journal.

While existing covered bonds will be grandfathered, issuers are likely to have an eye on the requirements of the proposed Directive when they come to update their programmes and for issuances even prior to the Directive requirements formally coming into effect. Although much of the subject matter of the proposed Directive is not unexpected given the general direction of EU regulation, the devil – as always – is in the detail. Given that the Directive is a minimum harmonisation measure, much will also be down to how Member States transpose the requirements of the Directive into national law. It remains to be seen whether the goal of the initiative – to achieve a level of harmonisation across the EU – is really achievable.

BREXIT: IMPLICATIONS FOR SECURITISATIONS

With the latest Brexit extension, the proverbial can has again been kicked down the road. The UK now has until 31 October 2019 to either ratify the draft Withdrawal Agreement or face yet another no-deal Brexit cliff edge. In the meantime, sticking points such as the Irish border issue remain unresolved and the political divisions continue.

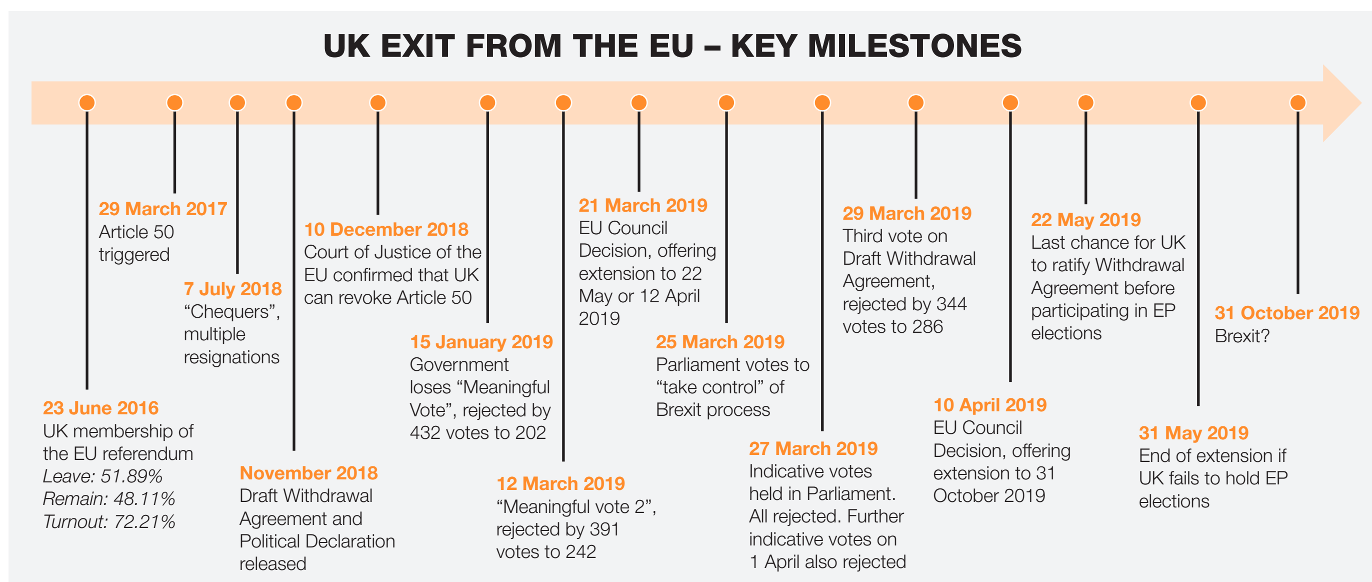
While securitisation markets have so far been more directly impacted by the Securitisation Regulation in 2019 than by Brexit, there are plenty of potential Brexit-related consequences looming in the near future. Most notably perhaps, the creation of a dual regulatory regime in the event of the onshoring of the Securitisation Regulation into UK law.

In this article, we provide a brief summary of Brexit to the date of printing, look at the possible outcomes and consider the potential implications for the securitisation market and its transactions.

Because Brexit remains a fast-moving issue we have not attempted to give an up-to-the-minute detailed analysis of the political situation. Rather, we focus on the more stable elements and attempt to point out some of the issues where preparation is more feasible. The main points are summarised in the timeline below.

How did we get here?

Since the notice under Article 50 of the Treaty on European Union was submitted on 29 March 2017, the possible Brexit outcomes can be grouped, broadly, into three categories: (i) revocation of the Article 50 notice and the UK remaining an EU Member State, (ii) a negotiated Brexit involving the signature of a withdrawal agreement between the UK and the EU followed by the negotiation and execution of a longer term agreement – this is the stated goal of most of the important political actors, and (iii) a "no deal" Brexit in which the EU treaties simply cease to apply to the UK with no transitional arrangements agreed between the parties. In analysing Brexit, it is useful to recall that, although almost all of the important political actors have expressed a strong preference for avoiding a "no deal" outcome, it remains the legal



default position if the end of the Article 50 notice period (including any extensions) is reached without a deal in place. Over the last three years there have been shifting red lines, numerous resignations and two extensions – but that default position has been one constant in a changing landscape.

The first two years of UK-EU negotiations culminated in the release of the Draft Withdrawal Agreement and Political Declaration in November 2018, intended to facilitate an orderly exit from the EU, and it is this deal that the Government has been attempting to secure support for ever since. It has been presented to the House of Commons three times between January and March 2019, but has been defeated each time. Attempts by backbench MPs to advance the process by a series of "indicative votes" designed to help clarify which proposals had the support of MPs proved no more successful.

There followed a series of extensions to the Article 50 notice deadline from the original deadline of 29 March 2019 to the latest deadline of 31 October 2019.

If no agreement can be reached by 31 October 2019, it is unclear whether a further extension (which requires unanimous agreement among the UK and each of the 27 continuing EU Member States) will be able to be obtained.

Potential Brexit outcomes

Revocation

The Court of Justice of the European Union confirmed on 10 December 2018 that it would be legally possible for the UK to unilaterally revoke its notice under Article 50. If this were to happen, the UK would remain an EU Member State on its current terms and no legal changes would result.

The Government has indicated that it has no intention of revoking the Article 50 notice, however. The indicative votes held in the House of Commons suggest that, as recently as 1 April 2019, there was insufficient support among MPs to force a change in that position. The only possibility being seriously debated at the time of publication that might lead to revocation is if there were to be a second referendum (often referred to as a "confirmatory vote" or a "people's vote") on the Withdrawal Agreement which results in a vote to remain in the EU.

Withdrawal Agreement

It is important to remember that the Withdrawal Agreement only deals with the UK's departure from the EU and is silent on the future relationship between the UK and the EU. It is the short, non-binding Political Declaration that accompanies the Withdrawal Agreement which sets out the plans for the future relationship, on which much of the recent political discourse is focused. At present, the wording of the Political Declaration is deliberately open-ended, reflecting the EU's insistence that detailed negotiations of the trade relationship can only take place after the conclusion of the Withdrawal Agreement.

The result of this is that the main provisions of the Withdrawal Agreement relevant for the law relating to securitisation is the transition, or implementation, period to provide time for such future relationship to be agreed. The current draft of the Withdrawal Agreement (which was originally due to come into force by 29 March 2019) provides for a transition period lasting until 31 December 2020, with the possibility of extending it by one or two years. If Brexit were to happen on those terms, the UK would not be a member of the EU, but it would be treated by both the UK and the EU as if it was still a member for most purposes (though not allowing the UK a voice or a vote in any of the EU institutions that it currently has as a Member State). This treatment would mean that EU law would continue to apply in the UK to the same extent as it does now and as such there would be little in the way of legal change relevant to the securitisation markets during the transition period (other than continuing with preparations for a post-Brexit world insofar as possible).

While the transition period would provide legal certainty with respect to the EU27 and the UK, it is not clear that all of the EU's trading partners with which it has free trade agreements would agree to honour this transition period. If they did not, then it is possible the UK might not benefit from the terms of the EU's free trade agreements during any transition period. To the extent that is relevant for the general economic environment, especially as it concerns the securitisation of, for example, shipping or trade receivables, it will be necessary to monitor the responses of the EU's trading partners in this respect.

No-deal

The Brexit outcome that has been the subject of most preparatory work is a no-deal Brexit. That is not to say that it should be considered the most likely outcome. Rather, it is a reflection of the fact that it has been necessary to prepare for "no deal" in order to support its credibility as a fallback option for the UK government. It is also a scenario where many of the variables are within the control of the individual parties, which provides the necessary certainty of framework to permit detailed planning. That said, no-deal remains a real possibility because it is the default option and Parliament has not voted in favour of any alternative.

The UK's no-deal preparations

The European Union (Withdrawal) Act 2018 (the "**Withdrawal Act**") provides the UK legal framework for Brexit and aims to ensure continuity in law in the UK following a no-deal Brexit. It provides for the domestic reproduction or "domestication" of the huge volume of EU law that currently applies in the UK by (i) repealing the European Communities Act 1972, (ii) "onshoring" and preserving most EU and EU-derived law as it stands immediately before the UK's departure, and (iii) giving the Government wide powers to correct deficiencies in retained EU law arising from the UK's withdrawal from the EU by way of amendments made by statutory instruments ("**SIs**"). Several hundred of these correcting SIs have been produced which, in general, replace references to EU and EU bodies with references to the UK and UK bodies and delete concepts which are no longer relevant (such as reciprocity between Member States). Most of these SIs have already been enacted into UK law but the provisions amending retained EU law will only enter into force on exit day.

In the event that the Withdrawal Agreement is ratified, additional (and amending) legislation would be required to reflect its terms, such as the continued application of EU law during the transition period.

Many of these SIs impact the securitisation market but none more than the Securitisation (Amendment) (EU Exit) Regulations 2019 (the "**Securitisation SI**"), which onshores the EU Securitisation Regulation. As with the other SIs made under the Withdrawal Act, the Securitisation SI is intended to correct deficiencies as a result of the onshoring and not – in general – to create new policy positions. Amendments include replacing references to ESMA and the EBA with references to the FCA and PRA, respectively. The result is that the UK will have its own securitisation regime under the onshored version of the Securitisation Regulation (the "**UKSR**") which will be separate but virtually identical regime to the EU's Securitisation Regulation (the "**EUSR**").

Several issues with the Securitisation SI have been identified, which could create legal and operational uncertainties for market participants. Industry bodies, with the support of law firms including Clifford Chance, have provided comments to HM Treasury, which drafted the Securitisation SI, but the concerns expressed seem so far not to have been reflected in any amendments to the proposed approach. Other issues are simply the result of the existence of a separate (if very similar) EU and UK securitisation regimes, to which the market would need to adjust. We consider these issues and implications further below.

Implications of a dual securitisation regime

If, following a no-deal Brexit, a dual securitisation regime is created by the entry into force of the UKSR, the implications would include:

1) "Frozen" EU law

The Withdrawal Act and Securitisation SI onshores EU law that is legally binding on exit day. In other words, it will not in general cover legislation which is published or planned but not yet applicable. This means that any of the level 2 rules made under the EUSR which are not applicable prior to a no-deal Brexit would not be automatically onshored into UK law. The technical standards relating to risk retention and securitisation disclosure are but two examples. These detailed rules make the securitisation regulation operational, given the ambiguity and/or lack of detail in the level 1 measures. Powers are given to UK authorities to make similar rules, but they are not mandatory and there is no guarantee they would be exercised to make similar or identical rules, if they are exercised at all. If any EU level 2 measures are not swiftly replicated in full in UK law, a divergence will develop between the EUSR and UKSR regimes.

In addition, the onshoring under the Withdrawal Act does not cover level 3 measures, such as guidelines and Q&As from the supervisory authorities, as these are not legally binding. Given its variability and complexity, the securitisation market relies more heavily than most on these types of more flexible, persuasive measures to assist with interpretation and application of the law to a variety of deal structures and asset classes. The absence of such guidance could therefore be problematic if not replicated swiftly by supervisory statements or similar stating that the UK authorities will honour existing guidance issued by the EBA and ESMA in particular. Already there are guidelines for the interpretation of the STS criteria under the EUSR and a Q&A document from ESMA on disclosure issues that are being heavily relied upon by market participants. These market participants will be keen for the new UK regulators under the UKSR to produce equivalent guidance and to engage and work closely with the UK market to overcome any potential issues.

2) Onshoring confusion

The task of onshoring thousands upon thousands of pages of EU law is truly herculean, and it is a virtual certainty that mistakes will be made just due to the sheer volume of the task. This difficulty is not helped by the fact that EU law is a moving target. The version of the Capital Requirements Regulation that was applicable when the onshoring SI started being written is already out of date, and

further significant changes are expected very shortly.

It is not surprising, then, that approaches in the various Brexit SIs to referencing legislation are inconsistent and can be confusing. While this is certainly a technical problem for lawyers, it is potentially a real problem for the markets to the extent that this leads to uncertainty about what the law is.

For example, because the SIs approach legislation thematically, there are often several SIs that onshore (and amend) a particular piece of legislation and it is not always clear what version they're onshoring or amending. In the worst cases, one SI will amend an existing EU regulation in a way that is inconsistent with the way another SI amends it, or in a way that rolls back or fails to take account of changes to the EU regulation since the onshoring work was begun.

This is before you take account of the fact that the SIs' references will sometimes refer to the ongoing EU version of a piece of legislation, sometimes to the "frozen" version on exit day and sometimes to the continuing version as it applies in the UK, while not always being clear which it is.

Many problems of these types have been identified and quite a number have been fixed as a result of industry efforts, but inevitably many issues will remain to be resolved once (and if) the metaphorical rubber hits the road.

3) Geographical scope

The EUSR contains the requirement that for transactions to qualify as 'simple, transparent and standardised' ("**STS**"), each of the originator, sponsor and issuer must be established within the EU. The UKSR equivalent of this provision only requires that the originator or sponsor are established in UK, and does not mention issuers (or securitisation special purpose vehicles (SSPEs)). In this regard, the UK STS regime under the UKSR would be more permissive than EUSR regime.

4) Risk retention on a consolidated basis

Another impact of this dual regulatory regime would be in relation to risk retention on a consolidated basis. Under both the EUSR and UKSR, retention is permitted on a consolidated basis within a financial group, meaning one group company can retain in relation to the securitised exposures of whole financial group on a consolidated basis. This could become problematic for a group that spans the UK and the EU. For example, an EU originator that relies on a UK parent company holding the relevant exposures to fulfil its risk retention obligations would cease to be compliant under the EUSR following a no-deal Brexit. Similarly, an EU parent could not hold the relevant exposures on behalf of a UK originator under the UKSR. Absent alternative arrangements, a no-deal Brexit could lead to existing transactions where risk retention is held on a consolidated basis ceasing to be compliant upon the UK's exit from the EU.

5) Data repositories and STS verifiers

The EUSR requires filings to be made to a data repository, authorised and regulated by ESMA, in respect of public securitisations (that is, ones requiring a Prospectus Directive-compliant prospectus). Under the UKSR, a separate authorisation regime would need to be developed for UK data repositories. In addition, existing UK data repositories would cease to be authorised by ESMA upon a no-deal Brexit, as the EUSR requires repositories to be located in the EU.

The same issue exists for third party verifiers of STS status. Current UK verifiers will cease to be authorised upon exit day and a new list of UK STS notifications will need to be established under the UKSR.

6) Licensing and passporting

On cross-border securitisation deals, transaction parties such as swap providers, account banks, arrangers and sponsors conduct regulated activities across the EU under current EU-wide passporting permissions. In the event of a no-deal Brexit, these passports would no longer be available to entities operating across the UK-EU border. These cross-border deals would require careful analysis to determine the regulatory obstacles, required licences and applicable exemptions.

For EU entities seeking to conduct regulated activities in the UK, the UK has produced a temporary permissions regime ("**TPR**"), which would allow EU entities that currently rely on passporting rights to continue their activities in the UK for up to three years after exit day. Entities that want to take advantage of the TPR will need to notify the FCA or PRA (as appropriate) in advance of exit day. Even without the TPR, the UK is in general relatively open to non-UK entities providing wholesale financial services to UK clients and counterparties, which may be able to rely on helpful exemptions and carve-outs from licensing and other regulatory requirements.

The position is more complicated for UK entities seeking to provide financial services on a cross-border basis into the EU27. Without the benefit of passporting, firms will need to carry out country-by-country and product-by-product analysis to assess whether they will be able to continue to carry on this business. This analysis reveals a

patchwork of differing approaches to licensing requirements (and exemptions to these requirements) for third country firms providing cross-border financial services into EU Member States.

For most transactions, it will be for the affected counterparties to ensure business continuity and the ability to fulfil their obligations for the life of the transaction. To mitigate the risk of disruption, transaction documentation should include robust replacement language allowing the replacement of any counterparty whose ability to perform its role is adversely affected by Brexit.

7) Risk retention for third country sponsors

As further discussed in the "Securitisation Regulation" section of this publication, there is an ongoing issue with definition of sponsors in the EUSR. Prior to the application of the EUSR, sponsors were defined in the CRR as investment firms regulated under the Markets in Financial Instruments Directive 2014/65/EU ("**MiFID II**"). However, the definition of sponsors in the EUSR refers to investment firms "as defined in" MiFID II, which extends to any investment firm with no geographical limit. Market participants have sought clarification from the European Supervisory Authorities to confirm that this is intended to be interpreted as broadly as it appears on its face but, at time of writing, such clarification has not been provided – which may be down to this being a politically charged question in the light of Brexit.

In the event that the authorities confirm that the sponsors must be MiFID II-regulated entities, this could pose an issue for risk retaining UK sponsors following a no-deal Brexit. Current UK retainers holding as sponsors will frequently be eligible because they are MiFID II-regulated entities. This could cease if they were to stop being MiFID II-regulated on exit day. On structures where a collateral manager fulfils the risk retention requirement as sponsor, there may not be another obvious MiFID II-regulated entity for such retention to be transferred to.

8) Ratings

A no-deal Brexit should not have a direct effect of the ratings of securitisation transactions beyond any more generalised economic impact. However, credit rating agencies may be concerned about the potential impact of the counterparty issues discussed above in relation to licensing (which can be mitigated by the inclusion of replacement language in transactions documentation). In practice, we would expect closer monitoring by credit rating agencies on complex cross-border securitisation structures.

9) Listing and ECB eligibility

If the UK ceases to be an EEA country, the Main Market of the London Stock Exchange ("**LSE**") will no longer qualify as an EEA regulated market and therefore it will cease to be an "acceptable market" in accordance with the ECB's eligibility criteria. Eligibility as ECB collateral is often important to bolster demand for bonds and aid liquidity.

To date, the ECB has given no indication of any special concessions or grandfathering arrangements with respect to the LSE's Main Market. However, on 1 April 2019, the LSE announced that, in order to continue to satisfy the ECB "acceptable markets" criterion following a no-deal Brexit, issuers of existing and new bonds listed on LSE's Main Market will be automatically admitted to MTS BondVision Europe without the need for the issuer to take any action, subject to the securities meeting the MTS admission criteria. MTS BondVision Europe is an "acceptable market" in the EU according to the ECB eligibility criteria.

10) Prospectuses and passporting

Passporting under the EU Prospectus Directive ("**EU PD**") regime allows a prospectus approved by a competent authority in one EEA jurisdiction to be used to make a public offer or to admit to trading on a regulated market in another. This reflects the uniform prospectus disclosure regime which applies for public offers and admission to trading in all EEA states.

Upon the UK's exit from the EEA, it will become a third country and the UK FCA will become a third country authority. Prospectuses approved by the UK FCA after exit day will therefore no longer be able to take advantage of EU PD passporting. There is, however, a question about how base prospectuses whose 12-month validity period "spans" exit day will be treated.

The SI which onshores the EU PD contains two significant features: first, that the UK FCA would continue to accept prospectuses approved by other EEA competent authorities prior to exit day for the remainder of the prospectuses' 12-month "life" (as well as any supplements); and, secondly, that it will also continue to accept EU IFRS.

Conversely, for prospectuses approved by the UK FCA prior to exit day, neither the European Commission nor ESMA have yet given guidance on whether they will still be treated by EEA competent authorities as valid for the remainder for the 12-month period after approval.

That said, the majority of EU PD-compliant prospectuses for securitisations are not base prospectuses and, in any case, are for bonds with "wholesale" denominations (that is, EUR100,000 or equivalent or higher). For those issuers, loss of passporting will be irrelevant (other than in the rare instance of seeking a dual listing in another EEA jurisdiction) because of the public offer exemption under the PD for wholesale debt.

11) Documentary issues

Contractual recognition of bail-in: Another consequence of the UK ceasing to be a non-EEA country, with no deal in place, is that it will become a third country under the Bank Recovery and Resolution Directive ("**BRRD**"). EEA entities subject to Article 55 of the BRRD are required to include a recognition of bail-in clause in contracts governed by the law of a third country which contain relevant liabilities. Affected contracts may include English law bonds, subscription agreements and facility agreements.

Following a no-deal Brexit, the UK will no longer be subject to Article 55 of the BRRD, but it will implement its own bail-in regime, which will require a bail-in clause in any affected non-UK law governed document to which a UK entity subject to the UK bail-in legislation is a party (broadly UK financial institutions, credit institutions and investment firms). The PRA and FCA have indicated there will be transitional relief available for their regulated entities entering into new non-UK law governed affected contracts (other than unsecured debt instruments) and grandfathering for existing contracts/liabilities. To date, no equivalent transitional relief or grandfathering has been offered by the relevant EU authorities.

References to EEA investors: The standard capital markets legending and selling restrictions which refer to public offers and salses within the EEA (such as EU PD selling restrictions) or which prohibit sales to EEA retail investors (such as MiFID II legending) will need to be adjusted to reflect that fact that the UK is a third country and therefore no longer within the scope of the current legending or restrictions.

Jurisdiction clauses: consideration may need to be given to adapting jurisdiction clauses in contracts in the event that the UK accedes to the Hague Convention following a no-deal Brexit. The Hague Convention provides for the mutual recognition and enforcement of judgments between contracting states, including EU Member States, in relation to contracts which include an exclusive jurisdiction clause. Therefore, post-Brexit, counterparties may need to consider whether to incorporate an exclusive jurisdiction clause in order to benefit from the Hague Convention or to retain the benefits of the flexibility offered by a more typical asymmetric jurisdiction clause.

12) Other practical implications

There are of course many other potential implications of Brexit and particularly a no-deal Brexit. The UK's withdrawal from the EU and consequential designation as a "third country" under EU law could impact on withholding tax analysis and on regulatory capital requirements, which may require transaction-by-transaction analysis. Further, the securitisation market does not operate in a vacuum and it is subject to wider macro-economic effects of the UK's withdrawal from the EU. These economic effects are unlikely to affect collateral performance of existing transactions beyond accepted thresholds unless conditions result in the downgrade of sovereign or bank ratings. Any downgrade of the UK's sovereign credit rating would be a particular concern for covered bond transactions and other transactions with specific ties to the credit ratings of sovereigns or banks.

Conclusion

The uncertainty of Brexit continues and is likely to do so in the near future. No-deal will remain a possibility (and indeed the default position) until another outcome is agreed upon. As such, the preparations for a no-deal Brexit will continue. Beyond preparedness and continued advocacy, there is only so much market participants can do and the smooth running of the markets in the future will depend on politicians and regulators, particularly in event of the creation of a dual regulatory regime across the EU and the UK. Brexit-related issues are far more likely to arise on cross-border deals, so the fact that the bulk of legacy transactions are functionally domestic (i.e. mainly connected to only one jurisdiction) will provide natural protection from many of the potential implications.

SYNTHETIC SECURITISATION AND SIGNIFICANT RISK TRANSFER: ADJUSTING TO THE NEW REGIME

The synthetic securitisation markets have been enjoying several years of resurgence following a nadir in the wake of the financial crisis caused largely by more sceptical regulatory attitudes. The opening months of 2019, however, have been less active than might have been expected on previous trends. In this article, we examine the state of the synthetic securitisation markets, the possible causes of this slowdown and how market participants are dealing with the challenges of the new securitisation framework.

After several years of rapid growth, 2018 was a year of consolidation for synthetic securitisation markets. Overall issuance volumes remained relatively similar to 2017, with a number of originators across Europe, as well as some from North America and Japan, executing transactions. As was the case in 2017, the United Kingdom was the largest market, with most of the large UK banks active.

2018 was also the final year in which the old EU securitisation framework applied to securitisations, including synthetic securitisation. Thus, there was a significant push by some originators to execute transactions before 31 December 2018 so as to take advantage of the one year grandfathering period, during which the pre-2019 risk-weights would apply to the senior retained tranches. Nevertheless, perhaps due to the reduction in this grandfathering period from the two years to one as a consequence of delaying the start of the new securitisation framework, there was perhaps less activity in the last few months of 2019 than had initially been anticipated.

One feature of the market which has remained fairly constant has been the fact that investor demand remains strong, although it also continues to be concentrated in a relatively small number of specialist investors who dominate the sector. While new investors have continued to emerge, in most cases they have been relatively small players, and have done little to challenge the dominance of the ten or so big investors in this market.

At time of writing, there have been relatively few transactions executed so far in 2019. To a large extent this reflects the highly cyclical nature of the synthetic securitisation market, which tends to see the vast majority of its activity in the second half, and particularly the final quarter, of each calendar year. However, it also reflects the fact that the industry is still coming to terms with the impact of the new EU securitisation framework. This framework poses some particular challenges in the case of synthetic securitisation.

The disclosure dilemma

The principal challenge derives from the new disclosure requirements. Until late 2018, most players in synthetic securitisation markets were expecting that the disclosure rules were unlikely to have a significant impact on synthetic securitisation, for the simple reason that synthetic securitisation transactions are almost exclusively executed in the private markets. Unlike most traditional securitisations, synthetic securitisations tend to be marketed to a relatively small number of potential investors, and are mostly not listed on regulated markets in the EU. As such, they fall within the scope of "private transactions" for the purposes of the Securitisation Regulation disclosure rules. For that reason, until the publication of the ESMA final report on the disclosure requirements in late August 2018, it was widely expected across the synthetic securitisation market (and indeed across securitisation markets generally) that private transactions would not be required to comply with the prescriptive disclosure templates that would apply to public transactions. Given that investors in synthetic securitisations have already required extensive disclosure of loan level information about the securitised exposures, it was generally thought that this would be sufficient to meet the level 1 disclosure standards set out in Article 7 of the Securitisation Regulation, without the need for significant changes to existing disclosure practices.

However, the change of approach by ESMA, requiring both public and private securitisations to comply with the new disclosure templates means that synthetic securitisations now do need to comply with these templates when any of the originator, sponsor, issuer (where applicable) or investors are subject to the Securitisation Regulation. This poses some significant challenges for many synthetic securitisations.

Unlike traditional securitisations which more frequently involve highly granular portfolios of consumer exposures, the majority of synthetic securitisation transactions involve portfolios of larger corporate exposures, such as revolving corporate loans, project finance loans, commercial real estate loans or other similar portfolios. This means that, given the number of fields which are required to be disclosed in relation to each underlying loan, in the case of portfolios of larger loans, it will often be possible for investors to determine the identity of the

individual borrowers, even if the templates are technically being completed on an anonymous basis. This creates significant challenges for many banks, as in most cases, disclosing such information will be contrary to the confidentiality provisions contained in commercial loan agreements, or other general banking secrecy obligations which apply in a number of jurisdictions. Although Article 7 of the Securitisation Regulation does acknowledge this risk, and states that parties should avoid such confidentiality breaches by disclosing information on an anonymous or aggregate basis, the nature of the proposed disclosure templates offer no means of achieving this. Thus, while in the case of a SME portfolio, it may well be possible to disclose the loan information on an anonymous basis without giving rise to these concerns, that is much more challenging in the case of a portfolio of larger corporate loans.

In particular, although for many fields originators are permitted to use the "Not applicable" ND5 field, the remains a large degree of uncertainty as to exactly what "not applicable" means in this context. In some cases, it must clearly relate to the relevant datapoint not being applicable or relevant in the case of a particular type of loan. However, in other cases, it can only sensibly mean that it is not applicable or relevant for the securitisation as whole. In yet other cases, it could have either, or both, of these meanings. It is likely that parties will need to wait for further guidance through the Q&A process to gain more clarity in this regard.

At a more practical level, the late stage reversal of approach on private securitisations by ESMA has meant that many originators in the synthetic securitisation space have been left trying to determine how to comply with the new rules. Again, unlike many traditional securitisation asset classes which have for many years been originated with the intention of being securitised, and where systems already exist to capture much of the necessary data in a format that is relatively easy to report, the origination of the types of loans commonly securitised using synthetic securitisation is more ad hoc, with much more diversity in approach between the individual exposures, and a greater need to adapt transaction structures and documentation to fit the particular assets being securitised. This means that, for many banks, they simply do not have systems in place to capture and report the necessary information. While these limitations are in many cases mitigated by the ability to use the "No data" options 1 to 4 in relation to many fields, some problematic fields remain.

What is particularly frustrating for the synthetic securitisation market is that, as noted above, this is a market where there has always been a high level of loan-level disclosure. Unlike traditional, rated, securitisations, investors in synthetic securitisations tend to invest in the first loss and lower mezzanine tranches, and thus conduct extensive due diligence of the loan portfolio, both before investing and over the life of the transaction. As this disclosure has been very much investor-driven, it has meant banks have been disclosing exactly the information which sophisticated investors consider is relevant to ensure that they are making an informed investment decision, which is entirely consistent with the principles underpinning the due diligence and disclosure obligations in Articles 5 and 7 of the Securitisation Regulation, respectively. In contrast, the ESMA disclosure templates have been drafted almost exclusively with traditional securitisation of highly granular exposures in mind, where most investors are investing in the senior tranches, and are thus much less risk-sensitive. From discussions with both investors and originators, it is clear that most investors in synthetic securitisations see little or no added benefit from receiving the additional information required to be reported through the disclosure templates. On the contrary, this forced disclosure creates additional headaches by potentially causing investors to need to sign up to more stringent non-disclosure agreements, more restrictive transfer provisions which reduce liquidity in secondary markets and potentially causing public side investors to be in receipt of inside information in relation to underlying borrowers. Thus, in the case of synthetic securitisation, the effect of ESMA applying a one-size-fits-all approach to disclosure, and mandating that all securitisations report using the same templates, is to impose on a sector of the market which already saw extensive loan-level disclosure a set of reporting templates which are unsuited to the nature of the product, are unnecessary and cause far more harm than good.

New hierarchies and mezzanine tranches

While the new disclosure requirements present the most significant practical challenges for originators seeking to execute synthetic securitisations, from an economic perspective, the biggest impact of the new securitisation framework comes not from the Securitisation Regulation itself, but from the accompanying amendments to the EU Capital Requirements Regulation. The most obvious change here has been the across-the-board increase in the risk-weights which apply to the most senior tranches of a securitisation. This is of particular importance for synthetic securitisation because in virtually all synthetic securitisations, the originator retains the senior tranche(s), and is thus directly exposed to these increased risk weights. As synthetic securitisations do not qualify for the reduced risk-weights applicable to positions in a STS securitisation, with the exception of a limited sub-set of SME transactions, this means the application of the new risk weights has a dramatic impact on the economics of a synthetic securitisation.

One emerging trend in response to these increased risk weights has been to see a thickening of the tranches placed with investors, and a corresponding reduction in size of the retained senior tranche (and a raising of the attachment point of those retained tranches). Since the financial crisis of 2008, the vast majority of synthetic securitisations have involved the placement of a single tranche with investors, be it a first loss or lower mezzanine tranche. However, given the relatively high coupon which usually attaches to such a tranche, it is difficult to increase the thickness of this tranche without the associated increased cost becoming unaffordable for most originators. While in theory the coupon should reduce as the overall riskiness of the tranche decreases, many investors in synthetic securitisations require a particular rate of return on capital deployed, making it difficult for them to lower their pricing expectations accordingly. One response to this has been the re-emergence of multi-tranche transactions, with originators starting to place additional, relatively thin, mezzanine tranches above the existing first loss or lower mezzanine tranche. As these additional mezzanine tranches have a much lower risk profile, they are attractive to different types of investors from those who invest in the traditional, risky, tranche, and who are willing to accept a lower coupon accordingly.

Two factors in particular are proving especially significant in this regard at present. First is the continued enthusiasm of insurers to participate in synthetic securitisation markets as sellers of protection. Unlike traditional investors (unrated hedge funds and pension funds), insurers have the benefit of high credit ratings, and are thus able to sell protection on an unfunded or uncollateralised basis. Free from the need to post collateral to the originator for the full notional amount of the protected tranche, such protection sellers are therefore able to accept a lower coupon than the traditional investors.

The other significant factor is the change to the risk weight hierarchies under the CRR. Under the old securitisation framework, the external ratings-based approach had precedence over the internal ratings-based approach. Because the external ratings-based approach generally produce a more conservative (i.e. higher) risk-weight than the internal ratings-based approach, this meant that originators were disincentivised from soliciting a rating for tranches in a synthetic securitisation, as the effect would be that they would need to use that rating for their capital calculations. However, under the new securitisation framework, the internal ratings-based approach (SEC-IRBA) (as well as the standardised approach (SEC-SA)) generally takes precedence over the external ratings-based approach. This means that an originator may solicit a rating for a placed tranche of a synthetic securitisation, without affecting its ability to use the generally more favourable SEC-IRBA methodology for its capital calculations. This opens up the placement of such tranches to investors who only invest in rated paper, and who would therefore previously have been excluded from synthetic securitisation markets by the lack of ratings.

It remains to be seen just how much these two factors do affect synthetic securitisation in the coming years. But the signs so far are that both factors are having an impact, which looks set to continue.

STS, SME securitisation and Article 270

As noted above, synthetic securitisations are not currently eligible to be classified as STS securitisations, for the simple reason that they do not involve a true sale which is one of the criteria for achieving STS status.

There is, however, a partial exemption from this prohibition in the case of a sub-set of synthetic securitisations of SME exposures under Article 270 of the CRR, which permits the originator of such a synthetic securitisation to accord the STS risk-weights to the senior retained tranche of such a securitisation. The precise requirements of Article 270 have been discussed previously.[1] However, what remains to be seen is to what extent originators will take advantage of the benefits which it provides. While SME exposures remain an important asset class for synthetic securitisation, they are dwarfed by the various categories of large corporate exposures in terms of issuance volumes. Further, the success of public bodies, primarily the European Investment Fund ("**EIF**"), in SME markets means that the vast majority of synthetic securitisations of SME exposures in recent years have involved EIF as the protection seller. The active involvement of EIF is therefore likely to be necessary in order to see a significant number of transactions structured to take advantage of Article 270.

Nevertheless, Article 270 remains an important opportunity for originators of synthetic securitisations to demonstrate that synthetic securitisation is compatible with the principles and aspirations underpinning the STS project. If a number of synthetic securitisations emerge which satisfy the requirements of Article 270, and thus satisfy most of the requirements for STS securitisation more generally, that will go a long way to demonstrating to regulators that STS securitisation can be expanded to include the much more significant (in terms of issuance volumes) larger corporate asset classes within the STS umbrella, which would have a significant impact for originators of synthetic securitisations.

1 See the article "Recent Trends in Synthetic Securitisation" in our publication *The New Spring for Securitisation* available here: https://www.cliffordchance.com/briefings/2018/05/the_new_spring_forsecuritisation.html

JAPANESE DUE DILIGENCE RULES: ANOTHER COMPLIANCE HURDLE?

Earlier this year, Japan introduced its first set of due diligence rules for Japanese institutional investors investing in securitisations. Similar to the rules applicable to institutional investors under the EU Securitisation Regulation, the Japanese rules are applicable regardless of the jurisdiction of the securitisation itself. However, the new Japanese rules appear to have been developed with greater flexibility than the EU rules to take account of market realities and the ability of institutional investors to make sophisticated judgments about what information is needed to make an informed investment decision. In this article, we consider the new Japanese due diligence rules, their effect on Japanese institutional investors' ability to participate in overseas securitisation offerings going forward and what overseas originators can do to ensure the continued ability of their Japanese investors to buy their paper.

Japanese investors have become increasingly active in the US, European and Australian securitisation markets in recent years, particularly with respect to CLO and RMBS transactions.
The significant investments they make mean arrangers and issuers listen attentively to their requirements. The introduction by the Japanese Financial Services Agency (the "**JFSA**") of new due diligence rules (the "**JDDRs**") for Japanese investors therefore commands attention in all the major securitisation markets. The JDDRs are set out in the Financial Services Agency Notices (the "**Notices**") provided for each category of financial institution (e.g. in respect of banks, the JDDRs are set out in Article 248 of the "Criteria for Judging Whether A Financial Institution's Own Capital Is Sufficient in Light of the Assets Held, etc. under the Provision of Article 14-2 of the Banking Law" (Notification No. 19 of 2006, the Financial Services Agency)). They bear similarities to due diligence and risk retention rules found in the EU and the US, though they diverge in a number of ways, therefore requiring an assessment to be undertaken on a case-by-case basis. The JDDRs became applicable to banks on 31 March 2019. Prior to their taking effect, on 15 March 2019, the JFSA released some guidelines and its views on questions put by market participants with respect to the application of the Notices (the "**Notice Guidelines**"), which alleviate earlier concerns that the JDDRs would exclude Japanese investors from many European and US securitisation transactions by providing that (i) if an investor considers them equivalent on the facts of the relevant rules, compliance with the US rules and/or EU rules will suffice for the purposes of the JDDRs and (ii) certain US securitisation transactions, such as open market CLOs, may not require risk retention for the purposes of the JDDRs. However, many of these deals will need to display triple compliance – with the US rules, the EU rules and, now, the Japanese rules too.

Applicability to Japanese investors

The JDDRs apply to Japanese investors which fall into certain categories ("**Japanese Institutional Investors**"). Among others, the JDDRs apply to all Japanese banks, all Japanese credit unions and credit co-operatives, the Norinchukin Bank, the Shoko Chukin Bank and ultimate parent companies of large securities companies. Given this scope, the JDDRs are relevant to most of the regular Japanese investors in US, European and Australian securitisations.

As the JDDRs apply to investors, they have only an indirect effect on transactions – issuers, originators and arrangers have no obligation to comply, but if their transactions fail to meet the requirements then Japanese Institutional Investors are expected to avoid them. Any issuers or arrangers seeking to access the Japanese capital markets should consequently ensure their transactions comply with the JDDRs.

The Japanese due diligence rules

The key definitions

Definition	Component elements
Securitisation Transaction	• credit risk on Underlying Asset • stratification of credit risk into two or more senior/subordinated tranches • some or all credit risk transferred to a third party • *not* Specified Loan Receivables
Specified Loan Receivables	project finance, object finance, commodity finance and business real estate lending
Originator	Either • directly or indirectly involved in the formation of the Underlying Asset • sponsor of an asset-backed commercial paper conduit or equivalent programme
Underlying Asset	Either • any one or more assets transferred by the Originator or any other parties to a securitisation SPV in respect of an asset-transfer-type Securitisation Transaction • any one or more reference obligations and guaranteed receivables in respect of a synthetic Securitisation Transaction

Relevance of timing

The JDDRs apply at the moment in time at which a Japanese Institutional Investor makes their investment in a Securitisation Transaction and, on an ongoing basis, each time the Japanese Institutional Investor is required to re-measure the amount of capital it is holding.

The JDDRs will, therefore, be relevant to Securitisation Transactions which closed prior to 31 March 2019 if a Japanese Institutional Investor looks to acquire an exposure to it after 31 March 2019.

There is a grandfathering provision for investments in Securitisation Transactions which a Japanese Institutional Investor held at the time the JDDRs came into effect, which applies so long as that Japanese Institutional Investor continues to hold that particular investment. The result is that the investment is exempted from the application of higher risk-weights even if the Securitisation Transaction does not satisfy the 5% risk retention requirement under the JDDRs.

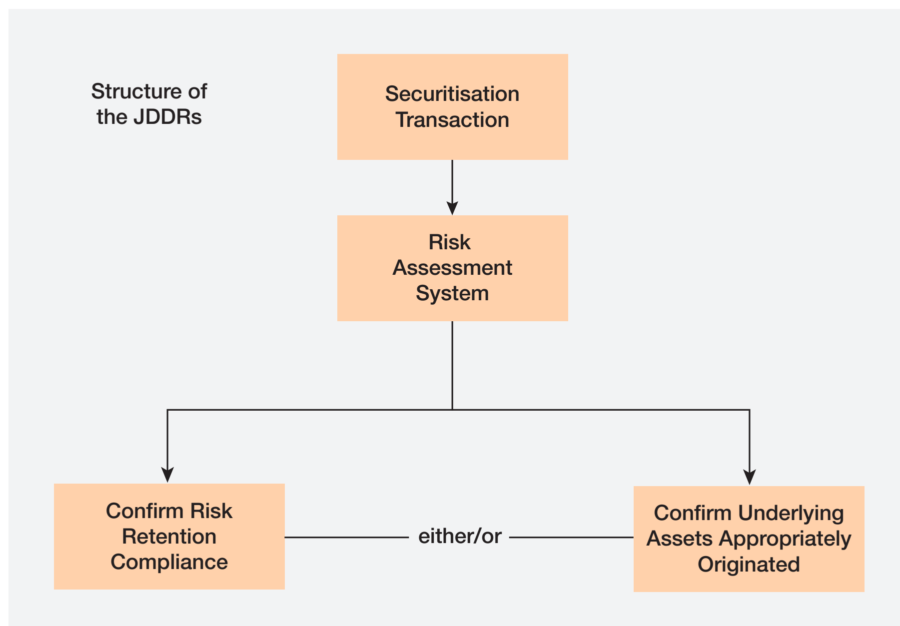
Structure of the JDDRs

The JDDRs affect the amount of capital a Japanese Institutional Investor must hold against a securitisation exposure and require a full capital deduction (i.e. a risk weight of 1,250%) unless the Japanese Institutional Investor appropriately establishes a risk assessment system (a "**Risk Assessment System**") to be applied to the specific Securitisation Transaction.

Further, even where a Japanese Institutional Investor establishes a Risk Assessment System with respect to the Securitisation Transaction, it must still triple the risk weighting to be applied to its exposure to the Securitisation Transaction (capped at 1,250%) unless either:

- that Japanese Institutional Investor is able to confirm that the Originator of the Securitisation Transaction retains a 5% interest in an appropriate form; or
- that Japanese Institutional Investor is able to determine that the Underlying Assets are appropriately originated, considering the Originator's involvement with the Underlying Assets, the nature of the Underlying Assets or any other relevant circumstances.

The establishment of the Risk Assessment System is, and should remain, a matter for investors to implement. However, confirming 5% risk retention, or appropriate origination of the Underlying Assets, is a matter which can be facilitated by appropriate disclosure and information sharing by the issuer and arranger of a Securitisation Transaction.



Risk Assessment System

The due diligence obligations imposed by the JDDRs require Japanese Institutional Investors to establish a Risk Assessment System in respect of each Securitisation Transaction. In respect of the Securitisation Transactions that a Japanese Institutional Investor invests in, its Risk Assessment System must involve, among others, a system which:

- can collect, on an ongoing basis, information on the comprehensive risk characteristics of the securitisation exposure of the Securitisation Transactions;
- can collect, in a timely fashion, information on the comprehensive risk characteristics and performance of the Underlying Assets of the Securitisation Transactions; and
- can identify the structural characteristics of the Securitisation Transactions.

The Japanese Institutional Investors must also prepare internal rules to ensure these systems are established and maintained.

The Notice Guidelines appreciate that investors may have systems which differ greatly from one another by reference to a number of factors (e.g. the detail of information collected, the frequency with which information is collected etc.) taking into account the proportion of the investor's portfolio consisting of Securitisation Transactions, the tenor of the Securitisation Transactions, the anticipated length the Securitisation Transaction will be held and risk. Consequently, it is expected that each institution's systems will mirror the risk profile and business model with respect to its investments in Securitisation Transactions. For instance, the systems of an institution which has almost no investments in Securitisation Transactions could be far less strict than the systems of an institution which holds investments in a large number of Securitisation Transactions.

Risk retention compliance or appropriate origination

Risk retention

The Notice Guidelines say that confirmation of compliance with the 5% risk retention requirement should be given by the Originator in writing. However, the Notice Guidelines appreciate that it may be difficult to obtain confirmation from the Originator in writing and, where that is the case, verbal confirmation of compliance may also be acceptable - for instance, on a management due diligence call or through an interview with the Originator or other related parties.

The Notice Guidelines recognise that where an overseas risk retention obligation is equivalent to the JDDRs, then Japanese Institutional Investors may treat the Securitisation Transaction as complying with the JDDRs if that Japanese Institutional Investor confirms that the overseas risk retention obligation is met. Furthermore, the Notice Guidelines state that where an Originator or any other party or parties equivalent to it (an "**Appropriate Risk Retainer**") is directly under risk retention obligations in other jurisdictions where the Appropriate Risk Retainer is obliged to hold an equivalent level of credit risk as required under the JDDRs, then the Japanese Institutional Investors may assume that the JDDRs are met without receiving any information from the arrangers in respect of the risks retained by the Originators unless there is a reasonable doubt that the Appropriate Risk Retainer may not be in compliance with the applicable overseas risk retention rule.

The JDDRs provide for compliance with the risk retention option as follows:

Who must retain risk?	the Originator
How much risk must be retained?	5% of the Underlying Assets being securitised The JDDRs are clear that this is re-tested continuously, however, the 5% will be calculated by reference to the remaining principal balance of Underlying Assets when tested after closing of the relevant transaction
Are there different retention options?	Yes – horizontal, vertical and L-shaped Any other retention of credit risk by the Originator which is “equal to or higher” than one of these options would also be compliant. This may, for instance, include a case where the Originator holds all of the most junior tranche which is less than 5% of the total principal balance of Underlying Assets and a part of the second most junior tranche with the result that the aggregate portion of the tranches held by the Originator becomes equal to at least 5% of the total principal balance of Underlying Assets, but such compliance would need to be assessed on a case-by-case basis by the Japanese Institutional Investor
Can the retained risk be hedged?	No – the JDDRs and the Notice Guidelines are clear that hedged risk does not constitute "credit risk" on the Underlying Assets. The Notice Guidelines say the Japanese Institutional Investors should seek a confirmation that credit risk is not hedged

Appropriate origination

As an alternative to requiring the Originator to retain risk, a Japanese Institutional Investor can alternatively comply with the JDDRs if the Japanese Institutional Investor is able to determine that the Underlying Assets have been “appropriately originated”. In determining appropriate origination, the JDDRs require each of the following matters to be taken into account:

- the involvement of the Originator in the origination of the Underlying Assets;
- the nature of the Underlying Assets; and/or
- other relevant circumstances.

The Notice Guidelines explain further what these other relevant circumstances might be, along with some examples.

Example	Suggested compliance options, as set out in the Notice Guidelines
Retention of credit risk in another manner which is equal to or higher than the credit risk imposed by the JDDRs	Retention of at least 5% interest by parties (other than the Originator) who are deeply involved in the creation of the Securitisation Transaction (for instance, the Originator's parent company, an arranger or a CLO manager). In the case where the Underlying Assets are receivables randomly selected from large pools of receivables, if the Originator retains credit risk which is equal to or exceeds 5% of the total exposures in the pool by continuously retaining all the receivables in that pool other than the Underlying Assets which are transferred to the Securitisation Transaction (or by continuously retaining particular receivables randomly selected from the asset pool).

Example	Suggested compliance options, as set out in the Notice Guidelines
A deep analysis of the quality (including the credit risk) of the Underlying Assets is made	Where the quality of the real property collateral securing Underlying Assets is appropriately assessed in an appraisal report or engineering report. Where a Securitisation Transaction is created from receivables purchased in the market, the Japanese Institutional Investor is able to confirm, based on subjective documents, that the quality of the receivables forming part of the Underlying Assets are appropriate. In addition, for transactions involving loan receivables, it is necessary for each Japanese Institutional Investor to verify individual loan receivables based on: • appropriate replenishment criteria; • the provisions of the contract (e.g. covenants and collateral terms) creating the loan receivables protecting the investor; • security interests created in securing the loan receivables; and • the Originator or the servicer being able to service and collect the loan receivables.
Where it is difficult to verify individual loan receivables	Each of the following: • an objective and rational standard is established as a basis for the acquisition and replacement of loan receivables by the securitisation-purposed conduit (i.e. no excessive discretion for the selection of the Underlying Assets is given to those involved in the formation of securitised products); • verifying in a timely manner that the acquisition and/or disposal of loan receivables are made in accordance with such standard, for example, by way of conducting a sample check; and • conducting stress tests based on reasonable scenarios and terms.

Open market US CLOs – open for business

One key concern in relation to the implementation of the JDDRs had been the effect they might have had on the ability of Japanese Institutional Investors to invest in open market US CLOs. The concern related to the fact that such transactions are not required to comply with the US risk retention rules and, consequently, would be unlikely to comply with the 5% risk retention requirement of the JDDRs.

Following a productive dialogue between the JFSA and various market participants, the Notice Guidelines include helpful context for structuring open market US CLOs in a manner which will comply with the JDDRs.

In particular, there is no absolute requirement for risk retention in Securitisation Transactions in order for a Japanese Institutional Investor to invest, provided that investor is able to confirm that the Underlying Assets have been appropriately originated. For example, with open market US CLOs, risk retention may not be required for Japanese Institutional Investors to invest to the extent that the investor is able to confirm from objective information that the Underlying Assets have been and are likely to be appropriately originated. Japanese Institutional Investors will need to determine if a Securitisation Transaction includes the transaction provisions needed to confirm this and, consequently, not require the Originator or arranger to retain risk.

Conclusion

Constructive consultation and dialogue between the JFSA and securitisation industry participants on the JDDRs prior to their implementation has resulted in a framework, supported by the Notice Guidelines, which achieves several objectives:

- first, enhanced due diligence standards for Japanese Institutional Investors will provide greater financial stability as volumes of investments in Securitisation Transactions by those investors continue to increase;
- second, there is no blanket ban on certain classes of transactions in which Japanese Institutional Investors invest – for instance, open market US CLOs; and
- third, there is a high degree of overlap with EU and US rules, allowing relatively easy dual-or triple-compliance in many circumstances. For example, if an investor considers them equivalent on the facts of the relevant rules, compliance with the US rules and/or EU rules will suffice for the purposes of the JDDRs.

While the JDDRs require some additional work by Japanese Institutional Investors in instituting new systems and processes, compliance with the rules should not require any significant adjustments to be made to the way securitisations are currently being structured in the market.

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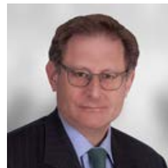

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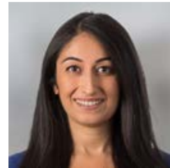

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