CLIFFORD CHANCE

STRUCTURED DEBT IN A NEW WORLD

FOREWORD

Much has changed since we published Testing the New Foundations back in 2019. Back then, we were mainly focussed on the (then new) EU Securitisation Regulation and how it would form a new foundation for securitisation markets in Europe. It feels now like we occupy a very different space – albeit a growing and vibrant one – whose worth is recognised increasingly as being an important and positive part of the global financial architecture.

A wide range of factors have contributed to the different world we now inhabit. The Covid-19 pandemic and responses to it, both temporary (like debt moratoria) and permanent (like the Capital Markets Recovery Package in the EU); Brexit finally becoming a reality years after the 2016 vote that approved it, with the multiplicity of consequences that continue to flow from that; the plethora of legislative measures to deal with non-performing loans; the rapidly increasing focus on ESG concerns taking both industry initiative and legislative form. All these have contributed to the feeling of operating within a new world being formed from the remnants of the old. We should also not overlook the impact of smaller, incremental changes. An ESMA Q&A here and a new RTS there, over time, can have a similar effect to a significant regulatory initiative even if it has less dramatic immediate effects.

Indeed, frequent change seems to be one of a very few constants in the world of securitisation. In the UK there is the Future Regulatory Framework exercise that is re-examining the entire system of financial regulation post-Brexit, including the securitisation regulatory framework. In the EU, there have been rumblings of change to the Securitisation Regulation for a little while now, and the Commission's plans in this regard are due to be published in its Securitisation Regulation review report imminently.

This year's publication, as ever, tries to help you to understand the main regulatory and market trends, the forces for change affecting our world, and distil the key lessons needed to help you and your business to navigate the constantly shifting landscape we all find ourselves in.

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CONTENTS

THE FUTURE OF THE SECURITISATION REGULATIONS IN THE EU AND UK: BREXIT AND BEYOND

The UK's withdrawal from the EU continues to present a number of challenges for parties doing cross-channel business. The securitisation regulatory frameworks in the UK and the EU, once unified, have already begun to diverge in substance as well as form. This has meant market participants need to consider which of the regimes apply to them and to their transaction counterparties, and what compromises are necessary to continue to get deals done. In this article, we examine some of the divergence that has already happened, consider areas of possible future development of each regime and review how market participants are managing the increased complexity that results from having to comply with the new regulatory landscapes.

Introduction

The EU Securitisation Regulation (Regulation (EU) 2017/2402 (the "**EUSR**")) began to apply on 1 January 2019, consolidating securitisation rules previously found in various EU regulations and directives, into a single harmonised securitisation regulatory framework. When the Brexit transition period ended at the end of 2020, the European Union (Withdrawal) Act 2018 (the "**Withdrawal Act**") onshored the EUSR and simultaneously made a number of changes to it. The EUSR as it forms part of UK domestic law by virtue of the Withdrawal Act is commonly referred to as the UK Securitisation Regulation (the "**UKSR**"). Not long after the end of the Brexit transition period, the EU approved a number of changes to the EUSR as part of its COVID economic recovery plan known as the "Capital Markets Recovery Package" (or "**CMRP**").

The UK's onshoring changes and the EU's CMRP changes are already creating the need for market participants to be conscious of cross-channel differences and decide whether to make explicit provision for them. In addition, because the regimes are no longer tied into lockstep, parties are also having to contemplate (and allocate) the risk of further divergence during the life of their deals. Indeed, further divergence is not a mere fanciful possibility; quite the opposite, it is a virtual certainty. The EU and the UK have each recently completed a wide-ranging consultation process on their respective securitisation regulatory frameworks, and each of them is likely to make amendments to its regime following this exercise, though (at the time of writing) only the UK's exercise has produced a final report so far[1]. The real questions, then, are how much the regimes will diverge, how quickly they will diverge and in what way they will do so.

As a result, entities regulated by one regime entering into transactions with counterparties regulated by the other may face difficult negotiations over how to deal with any mismatches in their rights and obligations at the time the deal is done, and also how to allocate the risk of any further mismatches arising as a result of future changes in law during the life of the transaction. The classic example is that parties may find that the "sell-side" requirements of the regime by which they are regulated as to risk retention and transparency do not meet the standards required to be verified as part of the "buy-side" due diligence requirements of the regime by which their investors are regulated.

Securitisation regulatory framework

Although the EUSR had been in place for two years by the end of the transition period, certain key elements of it had not yet been settled. The level 1 EUSR text requires a large number of key level 2 measures, known as regulatory technical standards and implementing technical standards (respectively, "**RTS**" and "**ITS**"), and level 3 measures, known as guidelines and Q&As, in order to explain and further specify its requirements. These level 2 and 3 measures are each developed by one or more of the European Supervisory Authorities ("**ESAs**") – the European Banking Authority ("**EBA**"), the European Securities and Markets Authority ("**ESMA**") and the European Insurance and Occupational Pensions Authority ("**EIOPA**") – to give further detail on the practical application of the level one text of the EUSR. However, some of these measures were not yet in force at the end of the Brexit transition period. To the extent that level 2 measures were in force and applicable at the end of the transition period, they were onshored into the UK

1 Review of the Securitisation Regulation: Report and call for evidence response, December 2021 (the "**HMT Review Report**")

regime. As to level 3 measures, the FCA and the PRA both published guidance to the effect that EU non-legislative materials published before the end of the transition period should continue to be applied in the UK to the extent that they remain relevant and unless or until they are changed by UK authorities. Further smoothing the transition was the relatively broad exercise of the temporary transitional power (the "**TTP**") by the PRA and the FCA, that permitted UK entities to delay implementing many onshoring amendments to Securitisation Regulation obligations until the end of March 2022.

Risk retention requirements

The most important of the level 2 measures that were not in force at the end of the transition period were the RTS in relation to the EUSR's risk retention requirements. The result of this is that the EU market has been relying on an old RTS adopted under the CRR[2] for detailed risk retention rules. This has been problematic because – while the market does have the level 1 text of the EUSR, a number of common risk retention structures rely on the more detailed rules set out in the CRR RTS. These include risk retention via full-support liquidity facility, vertical retention via a vertical tranche of the securitised asset(s) rather than the securitisation's liabilities and the way to deal with risk retention where there are multiple originators, original lenders or sponsors. There is the further issue that a number of new elements have been introduced into the risk retention framework since the CRR RTS was adopted, both by the original EUSR and the CMRP amendments. These include a formalisation of the ban on "sole purpose originators" and rules around fees paid to the risk retaining entity, both of which would benefit from the clarity that could come from a final RTS.

The uncertainty here has been amplified by the fact that the transitional rules set out in the EUSR grandfather only pre-EUSR deals, rather than deals done in reliance on the EUSR transitional rules. So any deal structured since 1 January 2019 in reliance on the CRR RTS but that does not comply with the final EUSR RTS on risk retention (when it eventually begins to apply) would theoretically cease to be compliant and would need to be restructured or wound up. It seems likely, however, that the market and regulators should be able to take a pragmatic approach to these deals, particularly if they have been structured with an eye to compliance with the CRR RTS and EBA's most recent draft risk retention RTS.

This situation does not look likely to be resolved for at least a few months, since (at the time of writing) the EBA has not yet published a final draft of the EUSR risk retention RTS[3] ready for adoption by the Commission. Mitigating the uncertainty is the high degree of consistency in the EBA's publications on risk retention. On most common market issues, the CRR RTS, the 2018 Draft RTS, and the consultation draft RTS published by the EBA in June 2021 (the "**2021 Consultation Draft RTS**") take a common – or at least a similar – approach. This has allowed the market to plan on the basis that the shared approach among the three texts is likely to be preserved in the final EUSR risk retention RTS. This cannot help, however, with novel issues under the original EUSR or the CMRP amendments, in respect of which the market has less reassurance until the final risk retention RTS are adopted.

UK onshoring

Relatively few changes were made to the Securitisation Regulation risk retention requirements as part of the onshoring process, so the EU and UK risk retention frameworks remained more or less identical in practice until the CMRP amendments came into effect in the EU in April 2021. Since no EUSR risk retention RTS had been adopted by the end of the Brexit transition period, no RTS could be onshored (although the PRA and FCA indicated an intention to onshore the 2018 Draft RTS more or less "as is" if they were adopted by the EU in time). As in the EU, the CRR RTS (onshored) continue to apply as a transitional measure. Also, like the EU, the UK has not yet adopted any risk retention technical standards (the UK equivalent to both RTS and ITS are called "binding technical standards", or "**BTS**"). The UK authorities' guidance about the continued application of EU non-legislative materials has been widely interpreted as guidance to the effect that the UK authorities broadly agree with the approach to risk retention proposed to be taken by the EBA in the 2018 Draft RTS. UK-regulated parties can therefore have some confidence that, if they follow the provisions of the CRR RTS and the 2018 Draft RTS, they will not find themselves at odds with their regulator when BTS are published in the UK in relation to the UKSR's risk retention requirements. The 2021 Consultation Draft RTS was published after the end of the Brexit transition period, so that is less relevant in the UK context. The changes between the 2018 Draft RTS and the 2021 Consultation Draft RTS largely result from the need for the latter to deal with the (EU only) CMRP changes in any event.

2 Commission Delegated Regulation (EU) No 625/2014 (the "**CRR RTS**").

3 For these purposes we are ignoring the Final Draft RTS published in July 2018 (EBA/RTS/2018/01) (the "**2018 Draft RTS**"), since the consultation on a revised version taking into account the CMRP amendments to the EU risk retention rules makes clear that that version will not now be adopted by the Commission.

Divergence, now and in the future

As explained above, the main problem caused by divergence is that deals structured to one jurisdiction's standards will not automatically meet the other jurisdiction's standards, making it more difficult to offer securitisations on a cross-border basis. Already, the EU's CMRP changes mean that certain NPL securitisations in the EU have to choose between taking advantage of the additional flexibility in the EU (principally, using the servicer as a risk retainer and measuring the 5% retention on the price the assets are sold into the deal, rather than their nominal value) and having access to UK investors. The other area of difficulty is that – since the end of the Brexit transition period – EU investors have not been permitted to recognise retention on a consolidated basis[4] where the parent institution is a UK institution. From 1 April 2022, the end of the TTP will mean that the reverse will be true as well, meaning UK investors will no longer be able to recognise retention on a consolidated basis where the parent is an EU entity.

The differences in risk retention rules that have arisen so far have been relatively minor irritants in that they only affect particular categories of deal, in that they can be relatively easily accommodated by structural adjustments, or both. It has been very helpful that the rules have otherwise been functionally identical. But what of the future? With one exception, the signs are encouraging. HM Treasury have confirmed that they generally view the current risk retention arrangements as satisfactory. So while they will look at areas of possible improvement, these would generally expand the range of flexibility available to parties when structuring their transactions. A few possibilities on the table include adjusting the rules for managed CLOs (including allowing the transfer of the risk retention in the event of a change in manager), NPL securitisations (possibly in a manner similar to the EU), allowing L-shaped retention (combination vertical and horizontal, as permitted in the US) and permitting synthetic excess spread to count as a risk retention piece on synthetic securitisations. On the EU side, no final report from the Commission's general EUSR review exercise has yet been published at the time of writing, but one specific question about risk retention from that exercise is cause for some concern. That question was about the possibility of requiring the risk retainer to be an EU entity in order to be recognised for EU purposes. If implemented, this would have the potential to require a variety of commercially inappropriate outcomes (e.g. retention by an EU original lender who is otherwise nothing to do with the deal because the securitisation "originator" who bought and securitised the portfolio is outside the EU) and could significantly hamper the ability of parties to conduct cross-border securitisation business.

Based on the evidence we've seen so far, it seems inevitable that the regimes will diverge, but it should still be possible to structure transactions in such a way as to cater for this. After all, this has been the approach taken for cross-border EU and US risk retention regimes for a number of years now. The regimes are – and for the foreseeable future are likely to remain – relatively similar, meaning (bar the potential EU requirement for the risk retention piece to be held in the EU) it should not become necessary to duplicate risk retention for the various different jurisdictions. It does, however, mean a bit more structuring complexity, and probably a need to comply with the risk retention rules of the jurisdiction that requires the largest risk retention piece. It also means managing the risk of further divergence during the life of the transaction. While in the past these issues have not always been covered in contracts (meaning each party bears its own regulatory risk but not the other party's), the recent tendency of EU legislation to provide little or no grandfathering threatens to make that a less tenable practice. Investors, for example, may try to mitigate the risks of future deviation by contractually requiring risk retainers to comply with both, or the stricter of the two, regimes. Naturally, this might be a difficult position to accept. A less sophisticated UK originator may quite justifiably not wish to be obliged monitor and comply with EU regulation with which it would otherwise have no connection. A more moderate position might be that the originator, original lender or sponsor is required to comply with the foreign regime as in force as at the closing date of the transaction, but then there may be a concern that the investor can no longer meet its ongoing due diligence obligations under the securitisation regulatory framework to which it is subject if stricter technical standards (or a more fundamental change) are adopted at a later date.

Transparency requirements

Comparable risks also apply in relation to other sell-side requirements of the securitisation regulatory framework, and their corresponding buy-side verification obligations. The EUSR and UKSR contain transparency requirements, which oblige the originator, sponsor and SSPE of a securitisation to make available certain information in relation to the securitisation before entry into and during the life of the securitisation. In a similar manner to the risk retention requirements, investors subject to the UKSR and EUSR are

4 As contemplated by Article 6(4) of each of the UKSR and the EUSR.

required to verify that the originator, sponsor or SSPE of a securitisation makes available the necessary information. Unlike the risk retention requirements however, RTS and ITS in relation to the EUSR's transparency requirements (Commission Delegated Regulation (EU) 2020/1224 (the "**EU Transparency RTS**") and Commission Implementing Regulation (EU) 2020/1225 (the "**EU Transparency ITS**")) were in force at the end of the transition period, and therefore became part of retained EU law, with only minor changes to the EU Transparency RTS (for example by referring to the FCA, PRA and the UK Pensions Regulator in place of references to competent authorities). This means that, with effect from the end of the transition period, divergent (albeit only minorly so) templates have existed for compliance with reporting obligations under the UKSR and under the EUSR.

As with risk retention, the exercise of the TTP by the FCA and PRA has helped to smooth the transition. Indeed, since the TTP permits compliance with old EU-style obligations, and since the reporting templates in the EU have not changed since the end of the transition period, in many ways the problems of divergence have yet to become a reality. Many UK originators have taken advantage of the TTP to carry on publishing their Article 7 reporting on EU templates, thereby eliminating any issues EU investors might have carrying out their Article 5 diligence obligations to check they're getting the right disclosure. Since UK investors have also benefitted from the standstill direction under the TTP, they have been permitted to accept EU templates even from UK originators for the purposes of carrying out their diligence obligations under Article 5 of the UKSR. The main change on the sell side, then, has been the need for UK sell-side entities to report to securitisation repositories in the UK (and sometimes also in the EU in order to meet investor demands), since the repository reporting obligation was carved out of the standstill direction for obvious reasons.

From 1 April 2022, however, reporting on UK templates will be required. Strictly from the sell-side perspective, this change is relatively straightforward. The EU and UK templates are virtually identical, and UK sell-side entities have had fifteen months to make them. The trouble arises when the needs of the buy side are taken into account.

EU buy side issues

EU institutional investors have been struggling with Article 5(1)(e) ever since it began to apply on 1 January 2019. It requires them to check the sell-side parties have "where applicable" made available the information required to be disclosed by Article 7. The meaning of the words "where applicable" has been the subject of much debate, the details of which we will not rehearse here. Suffice it to say that there are a variety of views about what information institutional investors are required to obtain from third country sell-side entities. The most risk-averse investors require Article 7 side disclosure even from third country deals, whereas the most robust investors think they are fulfilling their obligations so long as they ensure they receive information that (in their judgment) allows them to properly understand the deal and the underlying assets. Unsurprisingly, most investors fall somewhere between these extremes.

The result of that uncertainty is that many EU institutional investors would feel able to buy a UK securitisation with only UK-style disclosure. There are nevertheless a significant number of large investors who feel more comfortable with EU-style disclosure to an EU repository (especially where there is a listing of a UK deal on an EU regulated market, as is frequently the case, e.g. with UK RMBS deals being admitted to trading on the regulated market of the Irish Stock Exchange). For this reason, and because the templates are so similar as to make dual reporting reasonably feasible for a sophisticated originator, a number of UK deals have provided for reporting on both UK templates and EU templates following the end of the TTP.

UK buy side issues

As part of the UK's onshoring process, it tried to settle the Article 5(1)(e) debate, making clear that UK institutional investors would have to check that Article 7 UKSR style disclosure was being made only in respect of UK sell-side entities. Where they were dealing with third country transactions, UK investors would only have to check they were getting "substantially the same" information as would have been required of a UK deal, provided with "substantially the same" frequency and modalities.

This has had the effect of narrowing the range of the debate on both ends. In the UK, the most robust investors no longer have scope to take quite so broad a view of the discretion granted to them to decide what information they need. Conversely, those investors least happy to take legal risk have some comfort that they do not need to get the exact information that would be required of a UK deal – provided it is "substantially the same" then that is sufficient.

For deals offered from outside Europe, UK investors on the more robust end of the spectrum find themselves with less legislative wiggle-room than their EU counterparts who are not constrained by an explicit requirement to obtain substantially the same information from third country deals as they would get from their own domestic deals.

So far as cross-channel business is concerned, though, the onshoring changes are a boon. At the moment, the market is very comfortable that EU and UK disclosure templates and repositories are "substantially the same". This makes it easy for UK institutional investors to invest in EUSR-compliant securitisations without having to make special provision to ensure they get the disclosure they need to fulfil their regulatory due diligence obligations. This will of course have to be kept under review as the regimes continue to diverge.

The future of securitisation disclosure obligations

This an area that is likely to change reasonably substantially over the medium term. Neither the UK (based on the UKSR review report from HM Treasury) nor the EU (based on the commentary by the ESAs, the questions in the Commission's consultation document and the industry response to it) is especially satisfied with the way disclosure obligations are working at the moment. There is a lot of focus – and general dissatisfaction – in both jurisdictions on the distinction between public and private securitisations, that brings with it the obligation to report to a securitisation repository.

In the UK, it seems likely that the distinction between public and private securitisations will be re-examined, along with the consequences of that distinction. In particular, HM Treasury has indicated that the requirement for a formal, approved prospectus may not always be the appropriate metric for distinguishing between a public and a private deal, and have acknowledged that "there may be certain specific situations in which more flexibility as to the format and content of disclosures would be beneficial, provided there is still sufficient information disclosed"[5]. They have said they will reconsider "both how securitisations are categorised as either public or private and what kinds of disclosure requirements are appropriate for private securitisations."[6] This strongly suggests that fairly significant changes are on the cards for the securitisation disclosure system in the UK, meaning that significant divergence from the EU system in the medium term is fairly likely. It is worth noting, however, that the disclosure templates for public securitisations are not explicitly up for fundamental review, so it may be that the divergence is more nuanced, with public securitisations staying relatively aligned between the EU and the UK, but private securitisations diverging more significantly.

Things are more difficult to predict on the EU side, partly because (at the time of writing) the Commission has not yet published its report following its own wide-ranging review of the EUSR[7]. We do, however, have the published views of the ESAs[8], the views of the High Level Forum on the Capital Markets Union[9] and the Commission's Capital Markets Union 2020 action plan[10], all of which are summarised in our briefing from June 2021. As we set out in that briefing, the direction of travel indicated by those publications is somewhat in tension. The ESAs' views tend toward more detailed and prescriptive rules about disclosure (and corresponding diligence obligations), whereas the High Level Forum and the Commission are a bit more nuanced and seem open to the idea of being less prescriptive. As with the UK, the emphasis of the discussion so far is not really about disclosure templates (with the exception of providing additional information about sustainability, already provided for optionally in the CMRP amendments) meaning that there is no reason to think that templates will change significantly in the short term, though the EBA report on sustainable securitisation (discussed in more detail in our article entitled "ESG Securitisation: Accelerating after a slow start") suggests expanding sustainability information requirements to all securitisations. This will also need to be reassessed after the Commission's review report, which is expected to be published within the next month or so.

Practicalities of managing divergence

Already many EU institutional investors are insisting on EU templates (and reporting to EU securitisation repositories where appropriate). If the level of divergence increases, so too will the number of investors on the EU side who feel they need to insist on this. Likewise, as divergence increases, it is possible that a point will come when UK investors can no longer comfortably conclude that the reporting obligations imposed under the EUSR are "substantially the same" as those imposed under the UKSR and will need to take contractual steps to ensure that they are receiving the information they need.

Market participants on both sell and buy sides, and in both the UK and the EU, will therefore need to consider the extent to which they provide for cross-channel distribution of transactions. Sell-side

5 HMT Review Report, paragraph 4.26.
6 HMT Review Report, paragraph 4.27.
7 https://ec.europa.eu/info/sites/default/files/business_economy_euro/banking_and_finance/documents/2021-eu-securitisation-framework-consultation-document_en.pdf
8 Notably from the ESAs' review report on the EUSR and their Opinion on the jurisdictional scope of application of the EUSR.
9 https://ec.europa.eu/info/sites/default/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf
10 https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union/capital-markets-union-2020-action-plan_en.

parties on each side of the channel will need to consider the extent to which they want their deals to be available to institutional investors on the other side of the channel. If that is a priority, it will likely come at the cost of providing some assurance to buy-side parties that they will be able to do their regulatory diligence throughout the life of the deal. The practical impact of this assurance may be negligible, but if the regimes diverge significantly, the costs could be significant too.

Other areas of development on the horizon

Beyond the basic risk retention, disclosure and due diligence obligations discussed above, there are a number of other areas where either there have been already been divergences between the EU and the UK or there are possibilities for divergence on the horizon. These include.

- **STS**: The substantive requirements for STS in the UK and the EU have stayed relatively similar, but each system is self-contained, in that each requires sell-side entities to be within its own borders (though the UK regime permits non-UK issuers). There is, however, more of a clear indication in the UK of a desire to open the STS system up (probably by means of an equivalence system) so that the benefits of the STS system can be extended to cross-border business. The main EU suggestion for changing the STS system is an unspecified allusion by the ESAs that they would like to examine whether the STS criteria could be simplified without reducing the quality of the standard.

- **ESG provisions**: Both the EU and the UK are developing their regimes for ESG finance, in significantly different ways. The UK is focussing on general requirements, such as the proposed Sustainability Disclosure Requirements announced by the Chancellor[11] in October 2021 and on which input has been requested by the FCA[12]. The EU, on the other hand, is taking a multi-pronged approach, with a number of requirements at the corporate[13], asset management[14] and bond-issuer[15] levels. There is a separate taxonomy regulation[16] that underpins all of this. In addition, there is an initiative for specific sustainability considerations to be introduced in the context of securitisation, with a report from the EBA on the topic recently published. This separate provision is despite the fact that securitisation is already explicitly included in the scope of the EU Green Bond Standard proposal (although the main recommendation of the EBA report on sustainable securitisation is that that label should be better adapted to the needs of the securitisation market).

In terms of wider regulatory movement, there is also a possibility of using the UK's newfound regulatory independence from the EU to reform the structure of the securitisation regulatory framework in the UK. This is part of a wider review (beyond the securitisation review exercise) called the "Future Regulatory Framework Review" which is looking at the wider system of financial regulation in the UK.

As applied to securitisation, one of the key proposals being considered is to move much of the regulatory framework from primary legislation (the EU model) to rules and guidance made by the regulators, the FCA and the PRA, through their Handbooks. This would allow policy to be made at a level closer to the individuals who have direct knowledge and experience of markets. It would also permit increased flexibility for UK authorities in adapting to changes in those securitisation markets. One possible downside of this change would be that it would represent a second significant shift in the securitisation regulatory framework (the first being Brexit onshoring) in the space of a couple of years – with all of the time and costs associated with updating compliance systems that entails.

Conclusion

So far the common solution to the problem of regulatory uncertainty and divergence, as is often the case in securitisation transactions, has been to agree sensible and commercially pragmatic contractual provisions. In part because of relatively small scale of divergence between the EU and UK regimes, these have so far been relatively easy to agree. However, unless and untill a formal equivalence regime is available or some other market consensus is reached as to common ground between the UK and EU regimes, we anticipate agreeing methods for compliance to become increasingly difficult as the UK and EU continue to work seemingly independently

11 https://www.gov.uk/government/news/chancellor-sets-new-standards-for-environmental-reporting-to-weed-out-greenwashing-and-support-transition-to-a-greener-financial-system
12 https://www.fca.org.uk/publications/discussion-papers/dp21-4-sustainability-disclosure-requirements-investment-labels
13 For example, the proposed Corporate Sustainability Due Diligence Directive: https://ec.europa.eu/commission/presscorner/detail/en/ip_22_1145
14 For example, the Sustainable Finance Disclosures Regulation: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088
15 For example, the proposed EU Green Bond Standard: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/european-green-bond-standard_en
16 https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en#regulation

on their respective regulatory frameworks, as evidenced by HM Treasury's lack of intention to make the change to allow for synthetic STS securitisation that has already been made by the EU.

Of course, it is worth bearing in mind in all of this that "divergence" is only a subject we discuss because we are used to the UK and the remaining EU countries being aligned as a single market with a single regulatory framework. In that context, all of these issues around different risk retention rules and disclosure requirements make sense and may sound cumbersome and even a little bit daunting.

However, if we stand back, this mindset has been with us for as long as there has been international commerce. European (EU and UK) sell-side entities wanting to sell into the United States are used to having to comply with US rules, for example. Henceforth, they will have to take similar approaches for each other as well. So it would appear that the future is simply that cross-channel business will become more cumbersome and costly, with the advantages that the UK and EU previously enjoyed when dealing with each other (as compared to, say dealing with the US) being eroded over time.

ESG SECURITISATION: ACCELERATING AFTER A SLOW START

Financing that takes into account environmental, social and governance ("**ESG**") factors has steadily been gaining prominence for several years. Investors across the board are increasingly seeking products which are not only financially robust, but which are also aligned with the broader ESG agenda. The best way to adapt securitisation to address ESG concerns has been a question for some time and has recently been looked into by the European Banking Authority in its report on "Developing a Framework for Sustainable Securitisation" (the "**EBA Report**")[1]. This article will explore the evolution of ESG concerns in securitisation from both a regulatory and a market perspective. It will look at the place of securitisation in the broader range of financing tools seeking to achieve positive ESG outcomes, as well as the challenges and opportunities it is facing.

General background

It is hard not to notice that ESG investment is booming – hardly a day goes by without ESG news in the main financial press. According to research from Bloomberg[2], ESG assets are forecast to represent a third of global assets under management by 2025. ESG financing figures for 2021 published by AFME[3] show the upward trend of new ESG bond and loan issuances. ESG bond and loan issuance volumes for the financial year 2021 were EUR749.8bn, up significantly from EUR396.4bn in 2020. While ESG securitisation issuances also increased in 2021 to EUR8bn (up from EUR2.1bn issued in 2020) with a mix of asset classes comprising consumer asset-backed securities and residential mortgage-backed securities, ESG securitisations still only made up 1.07% of ESG bond and loan issuances.

As these figures demonstrate, ESG securitisation volumes remain relatively modest as a proportion of the overall green and sustainability-linked financing market. One of the reasons for this may be a lack of a single, clear standard used to determine when securitisations meet ESG standards. As the EBA Report points out, there are at least three types of frameworks that are used to determine this, including (i) whether the securitisation is backed by ESG assets; (ii) whether the proceeds of sale of the assets into the securitisation will be used for some ESG purpose by the seller; and (iii) whether the key counterparties to the transaction commit to achieving certain sustainability-related KPIs. There is a further question about what counts as ESG or sustainability-related in the context of a securitisation.

This confusion about what metric to use for determining if a securitisation "counts" as ESG can make it even more difficult to meet those requirements. As alluded to in the EBA report, even a securitisation that qualifies as ESG purely on the basis of green use of proceeds by the originator/seller may – for purely reputational reasons – want to make sure that the assets backing it meet some kind of a minimal ESG standard (something akin to the "do no significant harm" principle from the EU Taxonomy Regulation) so as not to put off investors who may not wish to fund an "ESG" investment backed by e.g. high-emissions diesel cars.

Another reason ESG securitisation may not have got much beyond the starting blocks is that – to the extent the relevant standard is a securitisation backed by ESG-aligned assets – there is a clear lack of supply. Even where there are some clear options for how securitised assets could meet ESG criteria (e.g. excellent EPC ratings for homes financed in an RMBS or low emissions/electric cars for auto ABS), the inventories of these assets aren't sufficient to form the basis of a vibrant, liquid ESG securitisation market now. The EBA Report expresses concerns about this and it would seem from its Opinion on the proposal for an EU Green Bond Standard[4] that the ECB shares these concerns, although it expresses them less explicitly. We explore this issue further below.

1 https://www.eba.europa.eu/eba-recommends-adjustments-proposed-eu-green-bond-standard-regards-securitisation-transactions
2 Bloomberg Intelligence, "ESG assets may hit $53 trillion by 2025, a third of global AUM", available at: https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/
3 AFME, "ESG Finance Q4 and Full Year 2021 - European Sustainable Finance" available at: https://www.afme.eu/Publications/Data-Research/Details/-ESG-Finance-Q4-and-Full-Year-2021---European-Sustainable-Finance.
4 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021AB0030&from=EN (the "**ECB Opinion**")

Nonetheless, ESG securitisation as a tool for financing pools of assets, as opposed to financing corporates, is definitely gaining momentum. The first ESG securitisations started to appear in the European market from about 2017-2018 and quickly grabbed the headlines, and it is a testament to potential of this market that the IFLR structured debt deal of the year award for 2021 went to North Westerly VI ESG CLO managed by NIBC Bank.

What has happened so far?

There have been very few ESG asset securitisations in the main consumer asset classes to date. As mentioned above, other types of ESG financing, including corporate bonds and use of proceeds ESG covered bonds and, in the securitisation space, CLOs have led the way. This is partly because those deals are not limited on the supply side by availability of ESG assets the way securitisation would be. The most significant ESG securitisation deals we've seen in Europe so far have been the Green Storm RMBS issuances in The Netherlands, the Gemgarto Social RMBS, and Finsbury Square Green RMBS (both UK deals for Kensington) in the first half of 2021. Others are expected to follow.

While Green Storm is not explicitly linked to a set of ESG principles, the UK RMBS transactions of 2021 (including Yorkshire Building Society with Brass No.10) have chosen to align to the ICMA Green Bond Principles and the ICMA Social Bond Principles. For the Kensington transactions, the arrangers also took on an ESG structuring bank role, providing investors with soft comfort of third-party involvement in the process alongside the second party opinion provider who provides an opinion on the transaction and its economic sponsor (originator, in these cases), including benchmarking the use of proceeds, the asset selection and the originator's internal sustainability framework against external standards such as the ICMA Green Bond Principles.

Because of low levels of ESG asset availability, though, these deals have had to rely in large part on green use of proceeds by the originator, rather than green assets being used to fund the deal. For example, in Finsbury Square Green 2021-1, Kensington securitised £68m of green loans and committed to use the proceeds of the remainder of the class A notes to originate a further £570m of green mortgages over the following 5 years.

On the social side of ESG, market participants are still grappling with what it means to be a social securitisation. Clearly alignment to ICMA Social Bond Principles is workable, as Kensington showed with its Gemgarto 2021-1 issuance where the social project was making home loan finance available to applicants who are underserved by high street lenders using automated scoring processes given the complexity and characteristics of their income. Clearly the near-prime consumer credit market fits this bill squarely, especially with the use of credit builder products designed to improve or rehabilitate people's credit scores providing a ladder to prime products and rates in the future. The question remains whether this part of the market will seek to relabel itself as social. That, in turn, raises the question of whether relabelling of what is already happening as "social lending" will drive increased overall lending in underserved markets and drive greater energy efficiency in housing stock. Only time will tell.

Opportunities and challenges

The relatively modest size of the ESG securitisation market on the one hand and the ever-increasing investor demand for ESG investment opportunities across a broad range of debt products, from loans to securitisations, on the other present a clear opportunity for future growth of ESG securitisations. Indeed, recent research continues to demonstrate that investor demand in this space outstrips supply. Feeding into this trend is, among many other things, recent credit research demonstrating signs of positive correlation between the long-term viability of businesses and assets and its alignment with environmental, social and governance best practices.

While creating unique opportunities for growth of ESG securitisations, increased investor demand – combined with the relative under-development of the ESG securitisation market – creates two sets of challenges.

First, a lack of eligible collateral and verifiable, easily comparable, high quality information in respect of existing portfolios pitched against the heightened investor demand create risks of greenwashing and associated reputational concerns.

Second, the understandable desire on the part of investors for more standardisation, transparency and verification and the associated push for more regulation which would remove, at least to a degree, the risks of investing in something which is an ESG securitisation in name only, is juxtaposed against the risk of creating an overly regulated landscape with overlapping and conflicting frameworks, and the associated potentially prohibitive compliance costs.

Balancing between factors and considerations which are often pulling in opposite directions is probably the main challenge faced by the ESG securitisation market at the moment. Leaving the area completely unregulated and relying solely on the market initiatives is not an option which realistically remains on the table, given the relative complexity of securitisation as a financing tool and the multiplicity of regulatory frameworks already in place and in the pipeline. On the other hand, creating too much regulation – or putting relatively rigid regulation in at too early a stage – would hamper development of the ESG securitisation market and work against the objective of unlocking its potential in delivering funding to ESG-aligned goals and opportunities in sectors where other funding tools may be unavailable or commercially unattractive.

These challenges suggest that – at least for an initial period – a "use of proceeds" paradigm for ESG securitisation may be the best way for the market to prioritise ESG concerns while building up the stock of ESG-aligned assets needed to build a robust ongoing ESG securitisation market that can be backed by ESG-aligned assets.

Indeed, as mentioned above, the EBA Report acknowledges the concern about a lack of ESG-aligned assets as well as the concern about regulating too heavily and too early. Its main conclusion is that it is too early to put in place a specific framework for sustainable securitisation, preferring instead to recommend adjustments to the proposal for an EU Green Bond Standard to make it workable for securitisations – mainly by applying the issuer obligations set out in the proposal at the originator level, at least initially. This would have the effect of applying a "green use of proceeds" standard for ESG securitisation and provide an opportunity to build up a stock of ESG-aligned assets to grow a vibrant ESG securitisation market in Europe.

Regulatory framework and market initiatives

When looking at the current framework for ESG securitisation, it is worth noting that the more developed segments of the green, sustainability-linked and ESG finance markets have evolved over time from much the same place, as largely "bottom-up" driven, voluntary market initiatives. In the bond world, the main set of initiatives has been the ICMA Principles – including the Green Bond Principles, the Social Bond Principles and, more recently, the Sustainability-Linked Bond Principles.

Some of the challenges facing the ESG securitisation market – like the lack of standardisation, verification and consistency of information and greenwashing concerns – are also not unique to securitisation. The EU Taxonomy Regulation seeks to address some of these concerns by creating an overarching common language for discussing ESG concerns, targets and KPIs, thereby facilitating a shared understanding among corporates, financiers, policymakers and regulators.

The EU Taxonomy Regulation is an important example of the clear shift from industry-led initiatives to regulation in the determination of what counts as ESG, and securitisation is no exception to that trend. This has the potential to be a positive development, but in order for that to be true, policymakers will need to ensure that they do not move too quickly or make the criteria too difficult to comply with, with the result that they end up choking off a nascent market before it can flourish.

The pieces of regulation and upcoming regulatory initiatives relating to ESG securitisation can be divided into "buy side" and "sell side" regulation. We consider each below.

"Buy side" regulation

In the EU, the main piece of regulation which establishes the framework for both entity- and product-level disclosures applicable to asset managers is the Sustainable Finance Disclosure Regulation (or "**SFDR**")[5]. While its application to securitisations has largely been limited to CLOs to date[6], it is quite clear that this piece of regulation plays an important in setting the ESG agenda for financial investor community as a whole, including investors in securitisations. Unsurprisingly, an increased number of investor ESG deal requests coincided with the roll-out of the SFDR for precisely this reason. It should be noted that while the SFDR represents an important milestone in creating a standardised and predictable playing field for sustainability disclosures, both at the entity and product levels (in the case of the latter, by linking up with the EU Taxonomy), its requirements are sometimes difficult to apply to securitisations. This is because the SFDR often assumes a degree of control over the information flows which is more typical of a private equity relationship than of a fund investing in broadly distributed, traded debt or consumer assets. The recent proposal by the European Commission for a Corporate Sustainability Reporting Directive ("**CSRD**") is looking to significantly expand the scope of entities subject to sustainability reporting obligations to plug this gap in respect of corporate loans by ensuring that

5 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability – related disclosures in the financial services sector.
6 Securitisation products in general are not "financial products" for the purposes of SFDR and are therefore not regulated under it.

companies report the information which is required by investors and other market participants who are subject to the SFDR.

Similarly, although the EU Taxonomy Regulation represents a crucial step towards creation of a single sustainability "vocabulary" in Europe, it is also not always easy to apply to securitisations.

The UK did not on-shore the SFDR as part of its post-Brexit process. However, a framework mandating certain ESG disclosures for financial investors is also being introduced in the UK as part of the Green Finance Strategy adopted by the UK Government in 2019. In June 2021, FCA published two consultation papers on climate-related disclosures. One proposed climate-related disclosure requirements for asset managers, life insurers and FCA-regulated pension providers with the aim of introducing mandatory climate-related disclosures across the UK economy and of integrating the recommendations of the Task Force on Climate-related Financial Disclosures. Another consultation focused on disclosures by listed companies, but also included a broader fact-finding request seeking views on ESG prospectus disclosure for debt securities and possible regulatory oversight of third party ESG verifiers and ESG rating agencies[7]. The policy statement on climate-related disclosures by regulated entities, as well as a final version of the ESG Sourcebook, was published in December 2021. The first disclosures under the new rules will be required by June 2023.

Additionally, onshoring of the EU technical screening criteria, as well as to the international alignment issues, are also under consideration as it is viewed as important that any UK taxonomy recognises international standards due to the global nature of the issue of sustainability.

"Sell side" regulation

On the sell-side, the main regulatory initiative is the proposal for an EU Green Bond Standard ("**EUGBS**"). This proposal was largely inspired by the ICMA Green Bond Principles but was designed to give it formal regulatory status. The EU Green Bond Standard proposal picks up many of the Green Bond Principles, including taking a "use of proceeds" approach, requiring extra reporting on the "green" aspects of the transaction, and requiring external verification. It is also explicitly meant to include securitisation bonds. That said, the original Commission proposal for an EUGBS is not especially well-adapted to securitisations, imposing most of the relevant obligations at the level of the bond issuer in a way that would be inappropriate for many SPV securitisation issuers and failing to clarify how the proposal's use of proceeds approach should apply to securitisations. These have been the securitisation industry's chief criticisms of the EUGBS proposal, and they have also been raised in the ECB Opinion and the EBA Report. With any luck, then, the proposals will be amended by the Council, the Parliament or both before the end of the legislative process on the EUGBS so that the final legislative outcome is better adapted to the needs of the securitisation markets.

In addition to the EUGBS there are a number of initiatives both in the EU and the UK which are looking at securitisation as a financial product and, more specifically, at the framework for enhanced ESG disclosure for securitisations. Both the EU and the UK consultations on reviews of their respective Securitisation Regulations at the end of last year included ESG questions intended to solicit market feedback on the best approach to such disclosure. While the market views these initiatives as generally positive, the feedback received as part of the consultation processes, both in the EU and in the UK, uniformly encouraged a cautious and carefully balanced approach to requiring further ESG disclosure for securitisations. The resulting UK report suggested that HM Treasury has limited appetite for a specific sustainability framework just for securitisations. Given that we understand the equivalent Commission review report has been delayed in order to allow the EBA Report to be published, we currently expect that the EU will go in the same direction and focus its energies on the EUGBS and on the existing mandate for sustainability information to be published as part of the general Securitisation Regulation disclosure obligations (albeit this may be expanded to all securitisations rather than being restricted to STS securitisations as originally envisaged).

Lastly, given the increased focus on ESG, it is likely that the upcoming regular review of the EU Prospectus Regulation will consider green and sustainable bonds as part of the Strategy for Financing the Transition to a Sustainable Economy EU.

Conclusion

ESG finance in general and ESG securitisation in particular without doubt represent a significant, and ever growing, segment of the financial markets. Opportunities presented by ESG securitisation are important not only from the perspective of unlocking financing to those segments of the financial infrastructure which cannot tap into the traditional bond or loan markets but which nonetheless require investment aligned with the ESG objectives, but also – ultimately – from the perspective of achieving the climate change goals. Careful balancing of the competing demands and objectives in this space will be key to unlocking the full potential of ESG securitisations.

7 See further ESG publications at https://www.cliffordchance.com/expertise/services/esg/esg-insights.html.

NON-PERFORMING LOANS: THE EVOLVING LANDSCAPE

Sales of non performing loans ("**NPLs**") hit a four-year low in 2020, largely as a result of ongoing sales being put on hold as Europe entered lockdown and uncertainty regarding the performance of corporate and consumer debt. However, in recent months sales have risen significantly fuelled largely by government guarantee schemes. The most active jurisdictions have been Italy and Greece, with Italian sales constituting in aggregate approximately EUR 38.9bn, almost 60% of total sales in Europe.

In this article we examine some recent regulatory and market developments relevant to European acquisitions and financings of NPL portfolios. In particular (i) changes to Regulation (EU) 2017/2402 (the EU Securitisation Regulation or "**EUSR**") and to Regulation (EU) 2013/575 (the Capital Requirements Regulation or "**CRR**") which aim to remove some regulatory obstacles to the securitisation of NPLs; and (ii) the European directive on credit servicers and credit purchasers, including the standardised NPL transaction data reporting templates it will implement.

Amendments to the EUSR and CRR

The European Parliament adopted Regulation (EU) 2021/557 of the European Parliament and of the Council of 31 March 2021 amending the Securitisation Regulation (the "**EUSR CMRP**") and Regulation (EU) 2021/558 of the European Parliament and of the Council of 31 March 2021 amending the CRR (the "**CRR CMRP**") in each case as part of the "Capital Markets Recovery Package" – a response to the COVID 19 pandemic designed to aid recovery. The Securitisation Regulation had been criticised for failing to take into account the particular nature of NPL transactions and thereby hindering the securitisation of NPL portfolios. The amendments represent a welcome shift towards recognising the utility of securitisation as an ongoing funding tool to facilitate sales of NPLs, partly in anticipation of the predicted increase of NPL sales in Europe as a result of the impact of the pandemic.

The EUSR CMRP introduced the key definition of "NPE securitisation" for the first time. It is defined as follows:

> a securitisation backed by a pool of non-performing exposures[1] the nominal value of which makes up not less than 90% of the entire pool's nominal value at the time of origination and at any later time where assets are added to or removed from the underlying pool due to replenishment, restructuring or any other relevant reason.

The introduction of the definition of "NPE securitisation" is significant as it forms the gateway to take advantage of the flexibility introduced by the amendments. It is worth noting that portfolios in the market often consist of not only non-performing loans but also the resulting real estate originally securing loans that have been foreclosed against (REOs) and that such REOs are no longer credit exposures of any kind. They therefore fall outside both the numerator and the denominator when determining the 90% for the purposes of the NPE securitisation definition.

The EUSR CMRP also made certain updates to the risk retention regime, which previously proved problematic in the context of NPL securitisations. Following these amendments, the EUSR now allows for the credit servicer to act as the risk retainer, provided that the servicer is able to demonstrate that it has the relevant expertise and policies, procedures and controls in place. It is interesting that qualifying criteria differ from the standard suggested in the EBA Opinion (the "**2019 EBA Opinion**") which formed the basis of these amendments[2]. The 2019 EBA Opinion had made the case that an independent servicer would be an appropriate retainer where its "interests in the successful workout of the assets are appropriately aligned with those of investors". It cited in particular the example where the servicer retained "the mezzanine and/or junior tranche and its

1 Defined by reference to Article 47a(3) of the CRR.
2 Opinion on the regulatory treatment of non-performing exposure securitisations: https://www.eba.europa.eu/eba-publishes-opinion-regulatory-treatment-non-performing-exposure-securitisations

fees are payable out of the collections from the assets as part of the securitisation's waterfall". This test is manifestly sensible, as it ensures that the alignment of interests is appropriate while leaving the assessment of expertise to those with an economic interest in the most profitable workout of the assets – the investors. It also aligns well with the pre-amendment requirement for the originator, original lender or sponsor to retain so that their interests would be aligned with those of investors – without any particular regulatory requirement for expertise. So while it seems like an appropriate and helpful amendment to permit the servicer to retain the risk retention on NPE securitisations, it does seem very odd to substitute an expertise requirement in place of the more obviously economically appropriate requirement that the servicers' interests should be economically aligned with those of the investors.

The EUSR CMRP also adjusted the risk retention rules to allow the size of the retention piece to be calculated based on the discounted value of the assets after deducting the non-refundable purchase price discount (or "**NRPPD**") applied when the securitisation vehicle acquired the assets, rather than by reference to the nominal values of the assets. This is a welcome recognition that holding 5% of the nominal value of a portfolio of loans whose value is considerably impaired was disproportionate and in many cases required a prohibitively high equity investment. By way of example, where the assets are sold into the securitisation with a 90% non-refundable purchase price discount – not unrealistic for an NPL securitisation – a requirement to retain of 5% of nominal value of the assets would be equivalent to 50% of the acquisition price of the portfolio, making the transaction uneconomical[3]. It is hoped that this change will encourage the growth of the NPL securitisation market by making these transactions more commercially attractive on both the buy and sell side.

Lastly, the EUSR CMRP amended the verification requirements under Article 9, which previously required that sell-side parties on NPL securitisations must verify the original lender's systems and credit-granting criteria. It also required that sell-side parties verify that the same criteria and systems were applied to exposures regardless of whether they were to be securitised. This was obviously inappropriate for most NPL transactions, where the original lending criteria and systems have generally long-since stopped being relevant to a current credit analysis. The amendments now mean originators must apply sound standards in the selection and pricing of the NPLs in the portfolio and will need to satisfy themselves that sufficient due diligence has been done to support this. The principles behind the amendment are logical – the original test was often impossible to verify in the context of NPL portfolios which are well-seasoned and often disconnected from the original lender through the passage of time or multiple sales. The changes to Article 9 are (imperfectly) mirrored in the amendments to Article 5[4] and the diligence requirements of institutional investors in an NPL securitisation.

CRR CMRP

On 26 November 2020, the Basel Committee on Banking Supervision (the "**BCBS**") published the technical amendment *Capital treatment of securitisations of non-performing loans.* The rule, which the Committee started developing before the onset of the pandemic, recognises the differences between securitisations of performing and non-performing assets and sets out new capital requirements for non-performing loan securitisations which are meant to be more risk sensitive while still being prudent. The general consensus of the European industry is that these changes, while helpful, remain overly conservative. The technical amendment established a flat 100% risk weight for "qualifying" senior tranches of NPL securitisations (under SEC-IRBA or SEC-SA) and established a floor of 100% risk weight for other tranches (under SEC-IRBA or SEC-SA). A securitisation will be "qualifying" if the assets are acquired by the securitisation with an NRPPD of at least 50%. It also banned the use of foundation IRB parameters for NPL securitisations when using SEC-IRBA, meaning banks either needed approval to use advanced IRB (own estimates of LGD and conversion factors) or would have to use SEC-SA or SEC-ERBA to calculate their capital.

The EU implemented the BCBS technical amendment, with some modifications, via the CRR CMRP. The amended CRR allows, for example, the risk-weighting of qualifying senior tranches of NPL securitisations to be risk weighted as low as 50% if that would be permitted under the look-through approach in Article 267 CRR. It also permits the deduction of the

3 NPL transactions have always been able to use vertical retention in such cases, since vertical retention is sized based on the liabilities of the transaction rather than its assets, but this meant transaction parties were artificially forced into vertical retention when commercial logic might normally have dictated the use of one of the other four methods.

4 Article 5(1)(f), introduced by the EUSR CMRP mirrors the new requirements for NPL verification in Article 9, but fails to disapply the general requirement to verify credit granting standards, systems and processes under Article 5(1)(a) or 5(1)(b), as the case may be. This potentially leaves institutional investors in an awkward position of having to verify credit-granting standards, systems and processes which originators on the same transaction need not look into or disclose against.

NRPPD from the expected losses for purposes of calculating the maximum capital to be held against the securitisation position under Article 268.

As a general matter, these amendments are helpful, but European industry views them as not well-adapted with the European NPL market. From an industry perspective it would have been preferable to implement the recommendations of the 2019 EBA Opinion more completely. It would also have been helpful to set the minimum NRPPD for a "qualifying" NPL securitisation lower (at, say, 20%) and make clearer the precise circumstances under which the 90% minimum for NPE assets in the portfolio needs to be retested over the life of the deal.

EU NPL Secondary Markets Directive

Credit servicers, sellers and purchasers

The new EU NPL Secondary Markets Directive (or "**NPL Directive**") regulates the purchase and servicing of NPLs originated by EU banks and imposes new obligations on banks selling NPLs (whether to bank or non-bank purchasers), purchasers of NPLs and servicers and includes new disclosure, reporting and authorisation requirements. The aim of the Directive is to standardise the rules for credit servicers and credit purchasers across the EU and standardise disclosure in order to facilitate the sale of NPL portfolios while ensuring that borrowers' rights are protected. A recent trend across Europe has been that NPL investors have been focused on the acquisition of credit servicers to enable them to control the business plan, maximize their deal collections and benefit from servicing fee revenue. The effect of the EU NPL Directive is anticipated to be to lower the cost of entry for potential loan purchasers by increasing the accessibility and reducing the costs of credit servicing, which should be welcomed. However, the remit of the Directive poses certain challenges as a result of the harmonisation and licensing requirements and a tension with local law consumer protection regulations which, while generally derived from EU law, maintain certain local peculiarities which cross border servicing teams will need to be mindful of.

While the directive came into force on 28 December 2021, member states are required to adopt and implement the rules by 29 December 2023 and bring the rules into effect by 30 December 2023. Notwithstanding this, the broad impact of the Directive on sales, purchases and servicing of NPLs will result in market participants needing to take steps to implement the rules well in advance to ensure that they are prepared to comply with the disclosure, reporting, borrower protection and authorisation obligations.

NPL data templates

The EBA initially developed NPL data templates in December 2017 to support NPL transactions and enhance the functioning of the secondary markets in the EU but it has been acknowledged that they were not widely used by market participants due to their "voluntary nature and complexity". The templates will no longer be voluntary under the NPL Directive, as it will require their use in connection with the sale of NPL portfolios.

In parallel with the end of the legislative discussions on the NPL Directive, therefore, the EBA published a discussion paper setting out *inter alia* a number of changes to the existing templates intended to simplify their use for market participants including (i) reorganisation of the data categories and asset classes, (ii) reduction of data fields, (iii) classification of data fields as critical and non-critical, and (iv) the proportionality approach.

The revised templates which were the subject of the discussion paper are not anticipated to be final but are expected to form the basis of an additional consultation before the publication of the final ITS under the NPL Directive.

Market participants recognise that compulsory data reporting in respect of NPLs is inevitable and, while the market is supportive of the ultimate objective of transparency, it is clear from the discussion paper that there is a great deal of variation in how different institutions record and monitor information and also the data available depending on the nature and history of the related underlying exposure and the requirements of the relevant jurisdiction. The data fields that are capable of being populated in respect of, or indeed that are relevant to, a highly-seasoned NPL portfolio that has been bought and sold multiple times will not be comparable to that of a relatively homogenous portfolio being sold by the original lender of the exposures. While the wider securitisation market has significant prior experience in adapting to higher and more prescriptive transparency requirements, the ease of compliance with further NPL reporting requirements will hinge on the lead-in time industry has to adapt and the categorisation of only a limited number of data fields as critical.

And it is not clear that there will be significant lead-in time. The NPL Directive allows some grandfathering in that the diclosure templates apply mandatorily to credits originated on or after 1 July 2018 that became non-performing after 28 December 2021. That said, if a credit becomes non-performing before the final templates come into force (expected to be September 2022), then the data templates need only be completed with the information available. Accordingly we expect that the requirements will pose significant challenges given what we know of the NPL market, where there is currently little homogeneity in the form of data collected on exposures and where portfolios are bought, merged with other portfolios and onsold between both bank and non-bank market participants.

NPL transactions – recent market developments

During 2020 and 2021, there was an increasing use of securitisation techniques to finance the acquisition of NPL portfolios. Prior to 2018, 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 mortgage portfolios which were securitised at the point of acquisition or shortly thereafter. While such private senior loan transactions are still commonplace, the market is seeing more and more transactions, particularly in Greece, Spain and Portugal, that are being structured as public or private securitisations, while in Italy NPL transactions have been from the outset mostly structured as securitisations.

In the case of Greece, NPL securitisations have been structured mainly as private transactions, with Irish Section 110 Companies being the preferred buyer/issuer for tax reasons. Sponsors and originators can structure the sale and transfer of non-performing loans and credit receivables in Greece under one of two possible legal frameworks, (i) the long standing Greek securitisation law (Law 3156/2003) (the "**Greek Securitisation Law**") or (ii) the "new" Law 4354/2015 (the so called "**Greek NPL Law**"). The choice of the applicable legal framework depends largely on the objectives of the banks and the type of loans that make up the portfolio but the former remains the preferred tool of international investors for disposal of NPLs by banks, especially because of the requirement of the Greek NPL Law for the transaction to be subject to Greek law.

More recently, and since launching the Hercules Asset Protection Scheme (HAPS)[5], NPL securitisations in Greece have been required to adapt to the features set out in the HAPS Law. Although these transactions remained generally structured as private transactions, sponsors and originators have been required to take into account rating, listing, tranching and seniority requirements.

In Italy, NPL transactions are typically structured as securitisations, either public or private. This is done for a variety of legal, regulatory and tax reasons, among others. NPL portfolios are acquired by a special purpose vehicle established under the Italian securitisation law no. 130/1999. As the SPV is not a regulated entity (although it is registered in a special register with the Bank of Italy), the securitisation law requires that a bank or a regulated financial intermediary is appointed to service the portfolio. The acquired portfolios benefit from statutory segregation and the particular acquisition regime applicable to Italian securitisation vehicles allows them to benefit from an exemption from any security transfer taxes. Quite recent changes in the securitisation law extended the statutory segregation to the relevant REOCOs that operate within the context of – and for the benefit of – the securitisation.

In the case of Spain and Portugal, NPL transactions are structured using the relevant securitisation laws. In Spain structures use a securitisation fund vehicle (known as an "FT") and in Portugal they use a credit securitisation company (known as an "STC"), both of which benefit from the principle of statutory segregation pursuant to the national securitisation laws 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 avoiding the need to pay stamp duty as opposed to a sale and transfer of the NPLs and REOs as an asset transfer.

Conclusion

The legislative and regulatory changes discussed in this article have a set of common intentions, including reducing high-levels of NPLs building up on the balance sheets of banks, and facilitating the use and growth of a secondary market for sales and purchases of NPL portfolios. It should be noted that as at 31 December 2020, the UK and EU positions were largely identical, meaning the EU changes (the CMRP and the NPL Directive) represent a divergence between the two regimes. It remains to be seen whether the direction of travel for the UK will match that of the EU.

Notwithstanding the good intentions, it is far from clear that the changes made by the EU actually achieve their objectives.

5 The HAPS programme is similar to the Italian GACS whereby the most senior tranche of notes benefits from a government guarantee.

The market expectation is for NPL disposal volumes and associated financing transactions to continue to rise, driven largely by demand from banks to reduce their balance sheet NPL exposure coupled with the continued appetite of experienced NPL investors to invest in the asset class. At the same time, the pandemic has increased the need for lending institutions to manage and deal with their non-performing exposures and it is anticipated that the volumes of NPLs on balance sheets will increase following the roll-off from government-mandated payment holidays and other borrower forbearance schemes.

COVID-19 AND SECURITISATION: LOCKING DOWN THE LESSONS

In a briefing published in 2020 entitled "FCA Payment Deferrals for Consumers and the Securitisation Market"[1] we concluded that lessons would need to be learned from the first wave of the Covid-19 pandemic in the United Kingdom and that changes would need to be put in place to ensure that financings of consumer assets are robust enough to withstand the prevailing macro-economic headwinds. In this article, we offer a view as to what changes may be needed by drawing on patterns observed in the responses of market participants to the impact of Covid-19 and the measures taken by the UK government and regulators to manage the pandemic on securitisation structures.

Impact of Covid-19 on securitisation

The global spread of Covid-19 has prompted governments and regulators around the world to adopt measures designed to halt or slow the spread of the pandemic. While different sectors of the economy have been affected to varying degrees, a common feature in many industries has been the partial or total interruption of revenue generating activity. A number of measures were taken in order to mitigate the impacts on the UK economy, including national responses at governmental level, monetary responses by the Bank of England and regulatory responses by the Financial Conduct Authority (the "**FCA**").

FCA's general approach

Regulated firms providing regulated credit products in the United Kingdom are subject to a principles-led regime. Those principles inform how firms should treat customers who are in financial difficulty and are set out in the FCA Handbook. Among other things, the Handbook requires firms to pay due regard to the interests of its customers and treat them fairly, a principle which is developed further in the Mortgage Conduct of Business ("**MCOB**") sourcebook in respect of mortgage and home purchase plan products and in the Consumer Credit ("**CONC**") sourcebook in respect of unsecured consumer credit products such as credit cards, consumer loans, high-cost credit and auto-loans. Instead of imposing additional new regulation on firms at a time of national crisis, the FCA's general approach through the pandemic has been to issue guidance setting out its expectations as to how the existing regulatory framework should be applied in light of the fast-changing exigencies of the Covid-19 pandemic, including to consumers facing financial difficulty as a result of it.[2] That guidance included, for a time, the issuing of blanket payment moratoria up to six months in total granted at the request of the debtor, without any assessment being required as to their actual need for forbearance. What is more, such payment moratoria were not permitted to be reported to the customer's credit file.

The FCA's most recent guidance specified that Covid-19 payment deferrals in respect of regulated MCOB and CONC products should end on or before 31 July 2021. Going forward, the FCA once again expects firms to adopt a tailored approach to customers who are experiencing payment difficulties as a result of the impact of Covid-19, including those who continue to experience payment difficulties after having had six months of payment deferrals, within the existing regulatory framework. While payment plans, repossessions and defaults may be considered, such measures must now be tailored and can once again be reported on the customer's credit file. Lenders will therefore also be able to report loans in respect of which forbearance is granted as being in arrears. The FCA maintained this approach even though the UK Government and devolved governments throughout the United Kingdom introduced further measures to limit transmission of Covid-19 in late 2021 following the emergence of the omicron variant.

In addition, during 2021 the new "Breathing Space" regulations (The Debt Respite Scheme (Breathing Space Moratorium and Mental Health Crisis Moratorium) (England and Wales) Regulations 2020) came into force in England and Wales providing access to statutory moratoria for borrowers who have consulted with a debt advisor or are suffering from mental health crisis.

1 https://www.cliffordchance.com/briefings/2020/09/fca-payment-deferrals-for-consumers-and-the-securitisation-marke.html
2 Note that in limited circumstances, such as some aspects of the persistent debt regime, the FCA has disapplied certain rules inconsistent with its guidance on a temporary basis.

For more information see our article entitled "Recent Developments in Consumer Finance: Keeping the engine running" in this collection. A separate regime has applied in Scotland for standard debt issues for a few years.

Commercial property

Separately, tenants of commercial properties were able to access Covid-19 payment deferrals from commercial landlords in respect of rent due, supported by legislative action by the UK Government. The Corporate Insolvency and Governance Act 2020, among other things, introduced a temporary restriction on the use of winding-up petitions until 30 September 2021. While the general restrictions under the Corporate Insolvency and Governance Act 2020 expired on 30 September 2020, more limited restrictions on winding-up petitions presented between 1 October 2021 and 31 March 2022 have been introduced pursuant to the Corporate Insolvency and Governance Act 2020 (Coronavirus) (Amendment of Schedule 10) Regulations 2021 (SI 2021/1029). The Regulations, which entered into force on 29 September 2021, prevent a creditor from presenting a winding-up petition in respect of commercial rent that is unpaid because of a financial effect which results from the Covid-19 pandemic. The UK Government has also temporarily restricted the use of the statutory Commercial Rent Arrears Recovery process by landlords until 25 March 2022. As a result of the Covid-19 payment deferrals granted by commercial landlords, commercial rent arrears in the United Kingdom are estimated to currently stand in excess of £7.5 billion. The UK Government has introduced the Commercial Rent (Coronavirus) Bill to Parliament in order to address the portion of commercial rent arrears accrued as a result of businesses being required to close during the 'protected period' of 21 March 2020 to 18 July 2021. The Bill, if it becomes law (at the time of writing it is awaiting its third reading in the House of Lords), would ringfence commercial rent arrears accrued during the protected period and introduce a temporary moratorium prohibiting enforcement for non-payment of ringfenced debt until the conclusion of arbitration to resolve the commercial rent dispute or, if no arbitration takes place, six months after the Bill is passed.

Impact of Covid-19 forbearance on securitisations

For securitisation market participants, perhaps the most significant impact of Covid-19 and the forbearance offered to mitigate the impact on debtors has been the temporary reduction in cash flowing through to transaction structures. While the FCA's guidance and other forms of Covid-19 forbearance provided vulnerable debtors with valuable breathing space in the midst of a crisis, increased levels of forbearance create numerous potential issues for securitisation structures which market participants have had to grapple with, most notably:

- practical considerations such as whether structures permit servicers to grant the forbearance envisaged and how to facilitate noteholder meetings during periods when the prevailing public health circumstances make in-person meetings impractical or unwise;
- operational considerations such as how to distinguish between loans in respect of which Covid-19 forbearance was granted on the one hand, and loans which were delinquent or in arrears for reasons unconnected with the impact of Covid-19 on the customer's ability to repay on the other hand;
- economic considerations such as the impact of reduced cashflows on economic covenants (where used), triggers and borrowing base calculations; and
- legal considerations such as the contractual consequences of a payment default should there be insufficient liquidity in the structure to absorb temporary reductions in cash available to the issuer.

Market reactions to mitigate the impact of Covid-19

Common considerations

The impact of Covid-19 forbearance and the resulting potential for temporary liquidity disruptions to be passed on to securitisations prompted two common responses from market participants in the initial stage of the Covid-19 pandemic in the United Kingdom. First, they had to consider *how* Covid-19 forbearance would be granted to debtors whose debt was, at the time, financed by way of a securitisation. Second, investors in securitisations wanted to see different types of delinquency broken out in data sets (as discussed in more detail below under the heading "Data", a practice not common prior to the Covid-19 pandemic) in order to fully assess, among other things, the impact of reduced cash flows from the assets on the issuer's ability to service its debt when considering the existing forms of credit and liquidity support for transactions.

Ability to grant forbearance

The operational question of *how* Covid-19 forbearance would be granted to debtors whose debt was, at the time, financed by way of securitisation required a close reading of the transaction documents. The majority of transaction documents empower servicers to grant forbearance to debtors provided that such forbearance is in accordance with applicable law, the prescribed standard of care and/or the credit and collections policy of the servicer. Transaction documents prohibited the servicer from granting forbearance to debtors, permitted it subject to creditor consent of some kind, or made it subject to conditions (which usually prevented the servicer from granting forbearance to debtors which had the effect of fundamentally altering the economics of the asset – changing the term of the debt or the principal amount outstanding, for example). The precise analysis, however, was largely dependent upon the nature of the assets being financed.

- In respect of regulated consumer credit, many market participants quickly accepted that servicers had the power to grant Covid-19 payment deferrals pursuant to the FCA's guidance on the basis that servicing agreements generally permit the servicer to act in accordance with applicable law or regulation. Issues were nevertheless observed in certain public deals such as auto-loan receivables securitisations, where the detail of how servicers implemented Covid-19 forbearance had potentially significant documentary consequences. Some public auto deals have historically included the concept of a 'non-permitted variation', in connection with which an extension to the term of a relevant personal contract purchase or hire purchase contract would trigger a buy back obligation on the motor finance company. The 'non-permitted variation' concept was introduced to guard against extension of the term of financed receivables where the financing structure was not designed to absorb extensions, but some motor finance providers found that the buy-back obligation was triggered as a result of servicers granting Covid-19 payment deferrals and extending the term of relevant financed receivables by way of modifying agreements. Other motor finance providers, as a technical Consumer Credit Act matter, characterised Covid-19 forbearance as a unilateral waiver rather than entry into of a modifying agreement. Such Covid-19 forbearance therefore fell outside of the scope of the 'non-permitted variation' regime and the resulting buy-back obligation.

- In respect of non-regulated assets which were not subject to the FCA's guidance, the analysis was more complex. Some transaction documents allowed the servicer to temporarily amend the terms of the underlying loan agreements without the need for investor consent. The 'permitted restructuring' concept was often used by servicers to grant Covid-19 forbearance which changed the economic profile of relevant financed assets, though the extent of the Covid-19 forbearance which could be offered pursuant to such concept depended upon a close reading of the documents to determine precisely what constituted a 'restructuring'.

Data

Prior to the Covid-19 pandemic both private and public securitisations provided data on loan delinquency alongside defaults, but some originators and/or servicers made no distinction between loans which became delinquent due to non-payment (arrears) on the one hand, and loans in respect of which underlying debtors had been granted forbearance under MCOB and CONC on the other. In addition, arrears reporting did not commonly break down the ageing of forbearance. Arrears and forbearance rates may have been sufficiently low that investors did not need to distinguish between types of delinquency in order to fully understand the credit risk position of the portfolio.

In the initial stages of the pandemic in the UK, some investors quickly realised that they wanted to see more data on delinquency type, in order to fully understand the extent to which they were exposed to assets in respect of which the underlying debtor had been granted forbearance. In order to be able to provide such data, and to comply with the regulatory obligation, where relevant, not to report to the debtor's credit record any Covid-19 forbearance granted pursuant to the FCA guidance, servicers had to consider whether their existing systems and policies and procedures were able to distinguish between: (i) loans which became delinquent due to non-payment on the one hand, and loans in respect of which underlying debtors had been granted forbearance on the other; and (ii) forbearance granted pursuant to MCOB and CONC on the one hand, and forbearance granted pursuant to the FCA's guidance on the other hand. To the extent systems and policies and procedures were unable to do so, servicers had to update them in relatively short order.

Type of securitisation

Private securitisations are typically structured as borrowing base facilities subject to financial covenants which, if breached, lead to structural consequences ranging from early amortisation of the debt and end of the purchase period to triggering an event of default. Alternatively, to the extent the borrowing base is breached as a result of an asset deficiency, there is sometimes an obligation to cure by injecting equity into the structure. Such financial covenants are often drafted by reference to both the portion of the portfolio which is delinquent and the portion of the portfolio which is in default. As a result of the reduction in cash flowing from the assets to the issuer which would follow from an increased number of assets being granted forbearance, market participants were rightly cognisant of the increased risk of financial covenants being breached. Such concerns were particularly felt by non-bank lenders providing regulated credit products because they were expected to follow the FCA's guidance but were unable to access the Bank of England's liquidity schemes. A large number of private securitisations entering into early amortisation or default would have undermined those originators' ability to write new loans at a time when the real economy needed liquidity more than ever.

On the public side, structural features including well-capitalised seller shares, overcollaterisation, liquidity facilities and cash reserves have generally been sufficient to absorb cash flow reductions as a result of Covid-19 forbearance granted in respect of financed assets. Widespread downgrades of rated debt have therefore largely been avoided. Accordingly, market participants can take comfort that public securitisation structures are sufficiently robust to withstand temporary disruptions in cash flow.

This was fortunate because public deals are also cumbersome to amend due to formal noteholder consent regimes requiring in-person meetings. Where amendments to public securitisations were required, participants quickly reassessed the traditional view of a noteholder meeting in light of the evolving public health environment and used existing trustee powers to prescribe additional noteholder meeting regulations. In this regard, we have seen changes to accommodate meetings being held virtually or in a hybrid manner (where some attendees participate in person and some remotely). In addition, market participants have more readily adopted electronic consent provisions in documentation. These provisions permit noteholder resolutions to be passed by noteholders communicating their voting intentions through the clearing systems, without needing to hold a subsequent noteholder meeting. While electronic voting provisions were crafted some years ago in response to the perceived inefficiencies of traditional noteholder meetings and the accompanying lead-in time for obtaining noteholder consent, virtual and hybrid meetings were specifically driven by public health measures which prevented meetings from taking place in person. Nevertheless, given the additional flexibility that these different options afford to all involved, it is likely that they will continue to be considered for new transactions.

There were also differences in response based on asset class. Notably, the definition of 'delinquency' in credit card, consumer loan and auto-loan securitisations commonly turns on payments being missed *when due*, whereas the definition of 'delinquency' in residential mortgage securitisations normally depends on payment being missed *when originally scheduled*. Covid-19 forbearance generally took the form of a waiver of the debtor's payment obligation or an amendment to the underlying loan agreement to alter the schedule of repayments, though in either case the debtor's payment is no longer due on a date when it was originally expected to be due. As a result, financial covenants in credit card, consumer loan and auto loan securitisations were not as vulnerable to being breached compared to those in residential mortgage securitisations.

Considerations in the short term

Covid-19 forbearance granted to customers of regulated consumer products came to an end on 31 July 2021 and it is unlikely that any Covid-19 forbearance offered by non-regulated firms to customers of unregulated products continued beyond this date either. While it remains to be seen whether large numbers of debtors continue to experience repayment difficulties as a result Covid-19 in the United Kingdom, servicers are now permitted to report missed payments to the debtor's credit file. If this occurs to a significant degree across portfolios then the resulting delinquency spikes once again risk financial covenants being breached, with the undesirable structural consequences described above.

By way of example, although the temporary restriction on the use of the statutory Commercial Rent Arrears Recovery process by landlords is in place until 25 March 2022, it is conceivable that the financial, minimum occupancy, rent yield, LTV and debt service covenants in any CMBS financing such rent receivables may come under stress in the coming months, requiring further waivers to be granted or temporary amendments to such covenants in the short term and/or long-term restructuring.

Considerations for the medium- and long-terms

Going forward, we anticipate that Covid-19 will have a lasting impact on securitisations in three areas:

- **Increased focus on the definitions of "arrears" and "delinquency".** We expect the close reading of these two definitions, which was discussed above, to continue in respect of both existing and new securitisations and in respect of all asset classes. Given that any forbearance, whether granted as a result of special Covid-19 reliefs or for other reasons which cause the debtor to struggle to make a repayment, will mean that a payment is not technically *due*, investors may want to either move towards the position of defining delinquency by reference to a payment missed when *due* rather than a payment missed when *scheduled* in order to avoid being caught unawares by any future temporary delinquency spike. Alternatively, investors may wish to specify that a subset of forbearance does not count towards the definition of arrears (for example, payment holidays of up to and including three months) but that any forbearance above and beyond this level will count. A more bullish approach would be for investors to adopt the position that all future forbearance will count towards arrears.

- **Continued investor demand for more granular delinquency and default data.** We expect that investors will continue to request, where relevant for a particular transaction, more data on forbearance and with a high level of granularity to enable them to fully appraise the risk position in an economic environment which is strongly influenced by a fast moving and ongoing public health crisis. We expect the type of forbearance (irrespective of whether it is Covid-19 forbearance), the number of defaulted loans, the month-by-month aging of forbearance and the number of loans in respect of which forbearance has ever been granted to be reported for some transactions. Others, where delinquency is perhaps less sensitive or where data is not available, may continue to publish data in the same way as before the Covid-19 pandemic. Closely linked to continued investor demand for more data and on a more granular level, we expect market participants will want to examine their transaction documents to ensure alignment with the servicers' systems. Likewise, there will be interest in ensuring the servicers' credit and collection policies are appropriate to ensure that forbearance is properly tagged and tracked operationally, and that it is reflected legally in the transaction documents, all of which is critical to support the ability to provide the data requested.
- **Support for transactions tapering over time.** While originators who securitise assets for funding purposes and who occupy strong market positions may, in particular, wish to continually maintain credit and liquidity enhancements (notably, the seller share and the level of equity in their structures) so as to be able to absorb a temporary cash flow disruption, we expect some of the new structural features introduced into securitisations over the past year to fall away. In particular, new securitisations are not including specific Covid-19 payment holiday reserves, but transaction parties are closely considering the level of liquidity reserves and, increasingly, incorporating liquidity facilities into the structure which can be drawn to fund a cure of a covenant breach.

In addition, we are expecting that electronic consent provisions are likely to be more regularly referenced. Given that agile working looks set to remain popular and the obvious time and cost savings of a more automated process, it may well be the case that physical meetings become even less common than prior to the pandemic. The long-term utility of virtual or hybrid meetings provisions remains to be assessed against the backdrop of recent experience, however. The trustee's existing power to prescribe further regulations allows a broad scope of flexibility which has been extremely useful during the pandemic but it is a discretionary power and subject to the trustee's usual fiduciary duties owed to noteholders. The challenge of writing these provisions more permanently into deal documentation will be to strike a balance between ensuring the framework is sufficiently detailed on the one hand and accounting for specific challenges and evolving practices on the other. Going forward, however, we expect that issuers will want to include an express power that will enable them to request further regulations, rather than relying solely on trustees' powers to do so of their own accord. Such entitlement would complement the existing power of the trustee to prescribe further regulations, but would enable additional flexibility insofar as the issuer could formally initiate the process to request virtual or hybrid meeting provisions on the basis that to do so is not materially prejudicial to noteholders.

While the trajectory of current governmental policy in the United Kingdom is pointed firmly in the direction of few, if any, legal restrictions of the type which have been so disruptive to revenue generating activities in certain sectors of the United Kingdom economy, the Covid-19 pandemic is not over and the public health situation has shown itself capable of deteriorating quickly as new variants emerge. Patterns may be observed from the responses of market participants to Covid-19 forbearance in the previous stages of the Covid-19 pandemic in the United Kingdom based on the type of securitisation and the purpose of the securitisation. Such patterns may be used to inform discussions regarding the structural modifications required, if any, to transactions going forward as a result of the continuing impact of Covid-19 and the measures taken to control the pandemic.

SECURITISATION IN LUXEMBOURG: NEW OPPORTUNITIES

Over recent years, the Luxembourg law dated 22 March 2004 on securitisation (the "**Securitisation Law**") has proven a successful framework for a wide variety of securitisation, repackaging and financing transactions. On 12 May 2021, a bill was introduced with a view to making small, but important adjustments to the Securitisation Law and clarifying certain questions in the interest of legal certainty. The changes entered into force on 7 March 2022. The main innovations are a significant broadening of the financing techniques available to Luxembourg securitisation companies and a welcome clarification that the Securitisation Law can be used as a legal framework for structuring managed CLOs. In this article, we set out more detail on the changes and their market impact.

As a preliminary note, it is worth remembering that the Securitisation Law and the EU Securitisation Regulation are two completely distinct legal regimes and it is perfectly possible for a transaction to come within the ambit of one, the other, neither or both. The Securitisation Law is an "opt-in" regime whereas the EU Securitisation Regulation applies mandatorily where the transaction meets the definition of a "securitisation", meaning that a vehicle which elects to be subject to the Securitisation Law may or may not be a securitisation special purpose entity for EU Securitisation Regulation purposes.

The innovations that have been made can be grouped into 3 categories:

i. Increased flexibility on the financing side
ii. Rules regulating the assets held by a securitisation vehicle
iii. Corporate governance rules

We examine each in turn below.

Increased flexibility on the financing side

Types of funding

The Securitisation Law used to require a securitisation vehicle to issue securities, the value of or return on which depends on the securitised assets. This requirement led to lengthy discussions about what counted as a "security" for these purposes, particularly in situations where the financing instruments issued were governed by foreign laws. It also led to significant complexity and uncertainty around the use of loan funding for leverage or liquidity management purposes, or during any warehousing phase.

The amended Securitisation Law now allows a securitisation vehicle not only to fund itself using any form of financial instruments (as opposed to the narrower concept of securities), but also using loans. In each case the value of or return on the relevant financial instruments or loans must depend on the underlying assets. This can easily be achieved by, e.g. making the loan limited recourse to the securitised assets, or ensuring that its value or return otherwise tracks those of the underlying. This change brings welcome simplicity to the discussion around the characterisation of the funding instruments which can be used and allows securitisation vehicles to be funded via loans such as asset-backed or profit participating loans.

Issuance to the public

Any securitisation vehicle issuing securities on a continuous basis to the public needs to be licensed by the CSSF. The Securitisation Law hitherto did not, however, define the concept of "on a continuous basis to the public", although the concept was clarified by the CSSF in its *Frequently Asked Questions*.

A statutory definition of this concept has now been introduced, thus increasing legal certainty. The amended Securitisation Law now provides that any vehicle issuing financial instruments to the public more than 3 times per financial year will be considered to be issuing "on a continuous basis" and therefore would require a licence. Moreover, the Securitisation Law provides that an issuance will not be made "to the public" if it meets any of the following three conditions:

i. The issuance is solely made to professional clients as defined in the financial sector law.
ii. The denomination of the financial instruments offered exceeds EUR 100,000.
iii. The financial instruments are distributed by way of a private placement.

These conditions are broadly based on the guidance provided by the CSSF except that it lowers the minimum wholesale denomination from EUR 125,000 to EUR 100,000. This is a welcome alignment between the Securitisation Law and the EU Prospectus Regulation (though worth noting a slight difference in that the EU Prospectus Regulation terms, the equivalent concept would be an exempt offer to the public, rather than saying it is not an offer to the public at all).

Rules regulating the assets held by a securitisation vehicle

Active management

Prior to the recent amendement, the Securitisation Law was silent on the question of whether a securitisation vehicle could actively manage its assets. This has now been addressed by specifying that a securitisation vehicle is only permitted to securitise a debt portfolio that is actively managed if the financial instruments issued for the purposes of such securitisation are not offered to the public.

This confirms that active management of a debt portfolio is possible unless the relevant securitisation is offered to the public, which would not normally be the case, given securitisations almost invariably have minimum denominations of at least EUR 100,000.

This clarification is very welcome as it removes any uncertainty as to whether active management of debt portfolios is permitted. With this clarification, Luxembourg looks set to offer an efficient legal framework for managed CLOs. That said, the amendments do not per se permit any reverse conclusion on securitisations of other asset classes and do not prejudice any arguments supporting the possibility for Luxembourg securitisation entities to actively manage their portfolio as the Securitisation Law will remain silent on this point (bar the above express prohibition).

Acquisition of real assets

Securitisation vehicles will now allowed to acquire the assets they securitise either directly or indirectly. Besides allowing the securitisation vehicle to directly own the assets generating the cash flows that are securitised (such as the assets subject to a lease if the lease receivables are securitised), this provision also confirms that a securitisation vehicle can acquire the assets or risks to be securitised indirectly, either through a wholly-owned subsidiary, or via the acquisition of an entity holding these assets or risks. This is helpful as compared with the previous regulatory position prohibiting securitisation vehicles from owning anything other than financial assets.

Granting of third party security interests

The Securitisation Law previously provided that a securitisation vehicle may only grant security over its assets (i) for the purpose of securing its own obligations in connection with the securitisation of those assets, or (ii) in favour of its investors. As a result, any security for the obligations of a third party may be null and void. Going forward, a securitisation vehicle will be allowed to give security for obligations relating to the securitisation transaction and does not exclude giving security for the obligations of third parties. This will, for example, allow a securitisation vehicle that acquires a junior loan to provide security over that loan in favour of the senior lenders, as is occasionally required. Until now, this has been a barrier to securitisation vehicles to acquiring such loans. Similarly, where the securitisation vehicle holds assets via one or more wholly-owned subsidiaries, it will now be possible to have the securitisation vehicle grant security, or give guarantees, for the indebtedness of its subsidiaries. The sanction that any security granted in violation of this rule is null and void has also been dropped, increasing legal certainty around transaction structuring considerably.

Corporate governance rules

New corporate forms available

Under the original Securitisation Law, securitisation vehicles were either established as a securitisation fund or as a company. In the latter case, only *société anonyme, société en commandite par action or société à responsabilité limitée* were permitted.

It is now possible to use tax transparent partnerships such as a *société en nom collectif, or a société en commandite spéciale as well.*

Partnerships subject to the Securitisation Law will need to prepare and publish annual accounts on the basis of the provisions of the law of 2002 on the register of commerce and on financial statements. They will not benefit from available exemptions in that respect.

Annual accounts and distributions

Where a compartment is financed by way of equity, the financial accounts relating to such compartment should be approved by the shareholders of the relevant compartment only. Similarly, in these cases, the determination of the distributable assets and reserves, as well as of the legal reserve, is made on a compartment by compartment basis.

Ranking of securities

Finally, a framework governing has been introduced the ranking of different classes of funding and, in particular, confirms that any form of debt ranks senior to shares, units and beneficiary units (unless otherwise agreed) and that fixed income debt ranks senior to participating debt.

Conclusion

The above changes will not fundamentally alter the Luxembourg securitisation regime, which is already very versatile and adaptable. The changes do, however, remove certain obstacles that may have rendered the structuring of some Luxembourg securitisation transactions more cumbersome.

RECENT DEVELOPMENTS IN CONSUMER FINANCE: KEEPING THE ENGINE RUNNING

The increasing popularity and widespread offering of "buy-now-pay-later" type financial products, often offered by unregulated specialist firms in the market, has recently brought increased focus to the regulation of consumer credit firms and the treatment of consumers thereunder. Coupled with the lingering effects of the FCA payment deferral guidance and the introduction of the Breathing Space Regulations, regulation of consumer finance offerings continues to be a developing landscape for creditors, debtors, and investors. In this article, we review some of the recent changes to the regulation of consumer finance and discuss their expected effects on securitisation of those products.

Buy-now-pay-later products and the Woolard Review Report

The rising prevalence of the "buy-now-pay-later" ("**BNPL**") market and the popularity of such financing offerings with consumers has resulted in recent media and political attention on the unregulated nature of the market and firms offering such products. As a result, in Q4 2020, the FCA instructed a review and report on the unsecured consumer credit market with particular focus on the BNPL market (the "**Woolard Review Report**").

The Woolard Review Report was published on 2 February 2021 and contained 26 recommendations covering a number of areas. Most notably, the review recommended that BNPL lending be brought within the scope of consumer credit regulation "urgently". On 21 October 2021 HM Treasury published a consultation on the regulation of BNPL products which closed on 6 January 2022. This consultation sets out a number of policy options in respect of the scope of regulation and the range of regulatory controls that could be put in place, focusing on those elements of lending practices most closely linked to potential consumer detriment.

Key recommendations arising from the Woolard Review Report

As highlighted above, the Woolard Review Report recommended that BNPL lending should be brought within the scope of existing consumer credit regulations. Although it did not say whether such lenders should be required to be authorised as full-scope or limited permission consumer credit firms, the Woolard Review Report clearly suggests a move away from allowing BNPL lenders to operate on an unregulated basis in reliance on an exemption under the existing regulations. The report focussed on a number of key areas of customer detriment that currently arise due to the unregulated nature of BNPL providers, including administration of late fees, referral to debt collection agencies, potential impact on credit scores through reports to credit reference agencies, lack of effective affordability assessments and the high risk of repeat borrowing from customers.

The Woolard Review Report also contained broader conclusions relating to the unsecured consumer credit industry, advising that measures should be introduced in the following areas:

- *Debt advice:* The report noted that the provision of debt advice is critical to a sustainable market in the long term, particularly in the context of Covid-19 and the ongoing effects thereof. The report highlighted that funding should be provided on a long-term basis to services that provide free debt advice to consumers. It also recommended that funding be put in place to help the poorest customers pay fees when applying for debt relief orders.
- *Alternatives to high-cost credit:* The report noted the importance of sustainable alternatives to high-cost credit for consumers and urged the government to reform the existing regulation of credit unions and community development finance institutions, as well as providing incentives for mainstream lenders to operate in this space and offer sustainable lending opportunities to consumers.
- *Forbearance:* The report recommended that the FCA examine how forbearance measures are implemented by firms (particularly when it comes to payment deferrals granted following the FCA Covid-19 guidance), and that greater transparency and consistency across regulated firms was needed in respect of what customers are offered. It also noted that Covid-19 payment deferrals are currently "masked" from credit

reference agencies as lenders were not permitted to report application of payment deferrals to such agencies, and the report urged further FCA studies on the market to examine whether this was the best approach for consumers on a long-term basis.

Finally, the Woolard Review Report recommended a fresh look by the FCA at consumer credit legislation generally to ensure that the legislation was producing the intended outcomes for consumers, with use of relevant products and services in practice as the relevant metric. Repeat lending to consumers was identified as a key risk area the FCA may look into with a view to further action. While current consumer credit rules under the FCA's Consumer Credit sourcebook (CONC) adequately addressed the initial affordability assessments carried out by firms, the report indicated that broader regulation should be introduced to address the risks posed by consumer lending throughout the life cycle of a product – for example, the risk of multiple credit cards which, individually, would satisfy firms' affordability assessments, but collectively left consumers at risk of persistent debt.

Breathing Space Regulations

On 4 May 2021, the Debt Respite Scheme (Breathing Space Moratorium and Mental Health Crisis Moratorium) (England and Wales) Regulations 2020 (the "**Breathing Space Regulations**") came into force. The Breathing Space Regulations seek to provide legal protections against creditors to individuals experiencing long term debt problems or mental health crises in the UK.

Most types of personal debts and in particular most types of unsecured debt will qualify for a breathing space, including credit and store cards, personal loans, payday loans and mortgage or rent arrears. A breathing space applies to all qualifying debts at the time of entry into the breathing space. Any new debts or arrears that are incurred during a breathing space do not qualify for the relief.

It should be noted that secured debts, including mortgages, hire purchase agreements or conditional sale agreements are not qualifying debts under the Breathing Space Regulations, with the exception of any arrears that already exist as at the date of application for a breathing space. Some other types of debt, such as debts incurred from fraud, court fines, student loans, child maintenance etc. are not qualifying debts regardless of when they arise.

Types of "breathing space"

The Breathing Space Regulations provide for 2 types of breathing space:

- *Standard breathing space:* Available to anyone with problem debt. The breathing space affords legal protections from creditor action for up to 60 days. The protections include pausing most enforcement action and contact from creditors and freezing most interest and charges on the debtor's debts.
- *Mental health crisis breathing space:* Only available to a debtor who is receiving mental health crisis treatment. It affords stronger protection versus a standard breathing space and lasts as long as the debtor's mental health crisis treatment, plus 30 days (no matter how long the mental health crisis treatment lasts).

Generally, a breathing space can only be accessed by seeking debt advice from a debt adviser. For a standard breathing space, the debt adviser must be satisfied that the debtor cannot, or is unlikely to be able to, repay all or some of their debt. The debt adviser is required to take into account the usual considerations around appropriateness of the debt solution for the individual at hand, including whether alternative solutions would be more appropriate (for example, assistance with budgeting or debt solutions that can be accessed more immediately). The debtor themselves must also satisfy certain conditions including not having been subject to an individual voluntary agreement (IVA), debt relief order (DRO) or undischarged bankruptcy against them at the time they apply, and not having been granted a standard breathing space in the 12 months preceding the application.

In order to qualify for a mental health crisis breathing space, the debtor must meet the conditions for a standard breathing space, and also be receiving mental health crisis treatment. Having had a standard breathing space in the last 12 months does not render a person ineligible for a mental health breathing space, nor is there any limit on the frequency with which a debtor can enter a mental health crisis breathing space. It should be noted that the mental health crisis breathing space is limited to those receiving acute mental health treatment and/or are being detained in specialist mental health service or institution, meaning the bar for applying is high.

Impact on creditors

Once a breathing space is applied, creditors (and anyone acting on behalf of creditors) are subject to restrictions and obligations imposed by the moratorium on collection and enforcement of debts, and creditors are restricted from applying interest and other charges on the qualifying debts subject to a breathing space.

Note that a distinction is different to a payment holiday; a breathing space only applies to debts that already exist when it begins. As such, although creditors are restricted from enforcing qualifying debts during a breathing space or charging interest or fees on that qualifying debt, a debtor remains legally required to pay their debts and liabilities and should continue to pay any non-qualifying debts and liabilities owed to creditors as they fall due. In fact, in the case of a standard breathing space, failure by the debtor to continue to pay certain ongoing liabilities (such as mortgage payments, local taxes, water bills etc.) could lead to the debt adviser cancelling the breathing space.

FCA payment deferral scheme

As consumers roll off existing payment deferrals under the FCA's payment deferral scheme introduced to combat the impact of Covid-19, there remain lingering considerations for firms relating to the treatment of consumers who continue to experience difficulties as a result of the ongoing Covid-19 pandemic. FCA guidance emphasises the overarching principles of ensuring affordability of credit for consumers and ensuring that ongoing and appropriate forbearance is made available to consumers to the extent needed as their payment deferrals come to an end. Although the impact of the specific Covid-19 FCA guidance has already started to tail off, the resulting themes from the Covid-19 related guidance are likely to continue, with increased focus from the FCA on firms considering each individual's (or cohorts of individuals') circumstances appropriately to offer sustainable forbearance measures.

New FCA "consumer duty"

The FCA published a consultation on a new "consumer duty" on 14 May 2021 (CP21/13), which would set higher expectations for the standard of care that firms provide to consumers. For many firms, this would require a significant shift in culture and behaviour, where they consistently focus on consumer outcomes, and put customers in a position where they can act and make decisions in their interests. The consumer duty would be a package of measures, including a new "consumer principle" that provides an overarching standard of conduct, supported by a set of "cross-cutting rules" and outcomes that set clear expectations for firms' cultures and behaviours. The consumer duty would give firms more certainty about the standards that the FCA expects of them and, correspondingly, the standards that consumers can expect of firms.

In this consultation (which has now closed), the two options for the new consumer principle were (a) "A firm must act to deliver good outcomes for retail clients"; or (b) "A firm must act in the best interests of retail clients".

The consultation specifically references certain consumer credit products such as credit cards as not being at all times fit for purpose – for example, the ability of customers with credit cards to over-borrow and under-pay is problematic, as are the opaque charging structures in many products. The introduction of this new consumer duty is likely to have a significant impact on firms' lending policies.

Notably, this consultation also considered the potential merits of extending the existing "private right of action" ("**PROA**") under section 138D Financial Services and Markets Act 2000 to include a right of action for a breach of the FCA's principles – as opposed to a breach of specific Handbook rules, as is the current position. This proposal is under discussion, but could significantly broaden consumers' ability to take action against firms which they consider have treated them unfairly. However, in its second consultation (discussed below), the FCA propose not to provide a PROA for breaches of any part of the consumer duty at this time.

The FCA published its second consultation on a new "consumer duty" on 7 December 2021 (CP21/36) which closed on 15 February 2022. This second consultation sets out the key feedback from the first consultation and the FCA's analysis of the responses, revised proposals for a new consumer duty with proposed Handbook rules and guidance, and a cost-benefit analysis. The FCA propose going ahead with the first option for the new consumer principle so that "[a] firm must act to deliver good outcomes for retail clients". This will be supported by three cross-cutting rules and four specified outcomes. The proposals under this consultation are not yet finalised, but the FCA has committed to publishing the policy statement summarising responses and setting out new rules by 31 July 2022.

Impact of developments

In practice, regulations such as the Breathing Space Regulations imposing a moratorium on enforcement and charging of interest or fees is likely to have a limited impact on securitisation cashflows. The widespread market expectation is that loans subject to a breathing space will not make up more than a small proportion of securitised pools. Manoeuvring securitisations and financings around requirements to ensure consumers are made aware of any creditor by assignment (which would, in a typical securitisation structure, include the relevant financing special purpose vehicle) is a matter originators and servicers will wish to consider. However, the practical impact is likely to be minimal where origination, legal title and servicing remain with the same entities, and managing the effect of the Breathing Space Regulations on an ongoing basis is likely to be mostly a matter of internal governance. With regard to transactions using third party servicers (as may be more typical in the acquired or third-party-originated space), the management of breathing space and notification requirements are likely to require some system adaptations.

As the recommendations in the Woolard Review Report start to be implemented and proposed guidance and/or legislation is published by the FCA, there is likely to be some noise as to the impact of the updated legislation and in particular how previously unregulated BNPL firms bring themselves in line with other regulated firms to ensure compliance with both the letter and the spirit of the regulation. The introduction of the new package of measures relating to the FCA's consumer duty will also require firms to carefully examine their existing policies and practices in dealing with, and lending to, consumers. Even where firms already have in place ongoing policies and procedures that are broadly in line with regulated products as a matter of good practice, a shift in outlook and policy is likely as firms adapt to a more closely regulated environment that is receiving increased focus from national regulators.

FUNDS AND SECURITISATION: WHAT DOES THE FUTURE HOLD FOR ASSET MANAGERS?

There has been relatively little change in the securitisation regulatory landscape for asset managers over the past couple of years. Asset managers have faced some challenges and uncertainties around interpretation of the scope of the EU Securitisation Regulation ("**EUSR**"), as it applies to alternative investment fund managers ("**AIFMs**"), including non-EU AIFMs and small AIFMs in particular. In the absence of interpretative guidance, AIFMs have necessarily had to take a view on how these rules apply to them today, leading to a fairly settled position across the market. However, in recent months, there have been a number of indications that changes are on the horizon both at EU level and in the UK. In this article, we review the recent and upcoming changes to the regulatory framework for securitisation as it relates to funds.

General background

In the EU, the European Supervisory Authorities ("**ESAs**") published an Opinion in March 2021 on the jurisdictional scope of application of the EUSR, recommending that existing uncertainties are clarified as part of the ongoing reviews of both the EUSR and Alternative Investment Fund Managers Directive ("**AIFMD**"). However, the European Commission's proposal to amend AIFMD published on 25 November 2021 does not directly address this issue. While the ESAs Opinion generally seems in line with existing market interpretations on the application of the EUSR to third country AIFMs, fund managers will still need to monitor how these uncertainties may be clarified in final rules (for example in case amendments are introduced as the AIFMD proposal makes its way through the EU legislative process or as part of the expected EUSR review proposal). It is also not yet clear whether or how potential application of due diligence requirements under EUSR to small AIFMs may be addressed, as again this was not included in the recently published AIFMD review proposal.

In the UK, HM Treasury has also consulted on its review of the Securitisation Regulation, including potential changes to limit the extraterritorial impact of the institutional investor definition to exclude non-UK AIFMs. This would reinstate the pre-Securitisation Regulation position for third country AIFMs and is likely to be a welcome change for the industry in a post-Brexit world, where overlapping EU and UK regulatory requirements have increased the compliance burden for asset managers doing business across the UK and EU.

Looking further ahead, fund managers should also start to consider the potential impact of the new EU Directive on Credit Servicers and Credit Purchasers ("**NPL Secondary Markets Directive**") on non-performing loan ("**NPL**") securitisations, and indeed the secondary market for NPLs more broadly. The new Directive forms part of the EU's action plan to tackle non-performing loans and will introduce new requirements on firms that purchase or are appointed to service NPLs, including in the context of securitisations.

While the new Directive ostensibly aims to help EU banks transfer NPLs off their balance sheets by introducing a harmonised regime for credit purchasers and servicers across the EU, it will also impose new due diligence, reporting and other information requirements, which may give rise to additional challenges and frictions. Nevertheless, given that parties to NPL securitisations already need to comply with extensive due diligence requirements under the EUSR, the NPL securitisation market may be better placed to implement and comply with the requirements of the NPL Secondary Markets Directive than other areas of the secondary loan market. Therefore, we expect the NPL Secondary Markets Directive may serve to reinforce the benefits of securitisations as a method for EU banks to transfer NPLs off their balance sheets overall. Member States are required to transpose these new requirements into national law by 29 December 2023 and apply them by 30 December 2023.

The recently published AIFMD review proposal also adds loan origination activities and servicing securitisation SPVs to the list of permitted activities for authorised AIFMs, to clarify that these are legitimate activities for AIFMs to carry on and to harmonise the ability of EU AIFs to originate loans in the EU, including on a cross-border basis.

ESAs Opinion on jurisdictional scope of the EUSR

When the EUSR replaced the pre-existing securitisation provisions under the AIFMD in 2019, it raised questions about the jurisdictional scope of the regime and how the requirements of the Securitisation Regulation apply particularly in respect of non-EU alternative investment fund managers ("**AIFMs**") and the funds they manage ("**AIFs**"). In the absence of official guidance or clarification on these issues, the industry has needed to operate on the basis of reasonable interpretations of the rules.

However, in March 2021, the ESAs published an Opinion acknowledging these areas of uncertainty and recommending that they are clarified as part of the ongoing reviews of both the EU Securitisation Regulation and AIFMD. While the ESAs Opinion generally seems in line with existing market interpretations, fund managers will still need to monitor how these uncertainties are clarified in final rules.

"Institutional investor" definition: application to non-EU AIFMs

The ESAs Opinion highlights potential inconsistencies between the definition of "institutional investor" under the EUSR and the obligations under Article 17 AIFMD for EU-authorised AIFMs to take "corrective action" in respect of exposures to non-compliant securitisations.

The definition of "institutional investor" in the EUSR includes an AIFM as defined in Article 4(1)(b) AIFMD that manages and/or markets an AIF in the EU. The definition of an AIFM under Article 4 AIFMD is not geographically limited and therefore this appears to capture non-EU AIFMs marketing AIFs in the EU.

This is broader than the pre-EUSR position, which imposed relevant requirements under Article 17 AIFMD only on EU-authorised AIFMs managing AIFs in the EU. However, the real question the market had to contend with in 2019 was whether or not this brought non-EU AIFMs into scope only with respect to the AIFs they marketed in the EU, or whether marketing a single AIF in the EU would bring the non-EU AIFM into scope with respect to all of its funds (even those not marketed in the EU).

Helpfully, the ESAs clarify in their Opinion that, in their view, non-EU AIFMs marketing AIFs in the EU should be considered institutional investors only with respect to the AIF(s) being marketed in the EU. We understand this is in line with interpretations that have generally been taken in the market on this point.

However, neither EUSR nor AIFMD currently sets out how non-EU AIFMs should be supervised for compliance with these requirements, including which national regulator(s) would be responsible for supervision in the case of non-EU AIFMs marketing AIFs in the EU. Following the ESAs Opinion, it is somewhat surprising that these questions have not been addressed as part of the Commission's proposed amendments to AIFMD published in November 2021. However, it is possible that the European Parliament or Council may propose further amendments that seek to clarify these points as the AIFMD review proposal makes its way through the EU legislative process, or that clarifications may be proposed as part of upcoming proposals to amend the EUSR. Alternatively, if formal amendments are not made to the AIFMD or EUSR on these points, the industry may continue to rely on established interpretations and/or relevant EU guidance such as the ESAs Opinion or Q&A.

"Institutional investor" definition: application to sub-threshold AIFMs

The ESAs Opinion also considers whether sub-threshold AIFMs are caught by the definition of "institutional investor". The ESAs note there is no explicit carve out from the definition of institutional investor for sub-threshold AIFMs, even though sub-threshold AIFMs are generally exempt from most requirements under AIFMD. In the Opinion, the ESAs do not express a clear view as to whether they consider sub-threshold AIFMs should be exempt from the EUSR requirements on institutional investors. Instead, they recommend that the position is clarified as part of the ongoing AIFMD review, which is looking at what requirements should apply to sub-threshold AIFMs more broadly.

In the meantime, the position remains unclear, although again neither EUSR nor AIFMD currently includes a framework for national regulators to supervise sub-threshold AIFMs for compliance with these requirements, if they were considered to apply. In the event that the AIFMD review concludes that sub-threshold AIFMs should remain out of scope of EUSR requirements (which appears to be the case from the Commission's recently published AIFMD review proposals), changes to the definition of "institutional investor" in the EUSR may also be needed to clearly reflect this.

Article 5(5) EUSR and ability to delegate due diligence

The obligations on institutional investors include requirements to carry out extensive due diligence prior to holding a securitisation position under Article 5 EUSR (unless the institutional investor is also the originator, sponsor or original lender). However, where the institutional investor has given another institutional investor authority to make investment management decisions that might expose it to a securitisation, Article 5(5) EUSR provides that the institutional investor can also delegate responsibility to perform this due diligence.

Importantly, Article 5(5) EUSR provides that this delegation to another institutional investor absolves the first institutional investor of regulatory responsibility to perform the due diligence itself – in contrast to usual principles of delegation, for example under AIFMD, where the delegating party retains regulatory responsibility for relevant obligations and is required to oversee its delegate's performance of those obligations).

The Opinion highlights this potential discrepancy between EUSR and AIFMD, although the exception to the general AIFMD delegation position is justified by virtue of the fact that a direct regulatory obligation is then placed on the delegate to comply with the Article 5 due diligence requirement. This is another reason why it is important for the uncertainties in the definition of "institutional investor" to be clarified, to determine whether or not an institutional investor retains responsibility for due diligence where it appoints a non-EU AIFM or sub-threshold AIFM as its delegate.

HM Treasury Call for Evidence on the UK Securitisation Regulation

HM Treasury also consulted on its review of the UK Securitisation Regulation ("**UKSR**") in June 2021 and published the outcome in a report dated December 2021. Like the ESAs' Opinion, HM Treasury highlights the extraterritorial impact of the current definition of institutional investor on non-UK AIFMs.

However, HM Treasury proposes taking action to narrow the territorial scope of the definition of institutional investor to take certain unauthorised, non-UK AIFMs out of scope of the due diligence requirements under the UKSR. In its call for evidence, HM Treasury highlighted that the extraterritorial application of due diligence requirements to non-UK AIFMs marketing AIFs in the UK poses potential challenges for supervision and enforcement, as such firms are likely to be outside the scope of the Financial Conduct Authority's ("**FCA**") regulatory jurisdiction.

In addition, HM Treasury noted that other non-UK institutional investors are not required to comply with due diligence requirements under the UKSR, and so the position of non-UK AIFMs is unique in this regard. Finally, HM Treasury considered it may be disproportionate to apply UKSR due diligence requirements to non-UK AIFMs and it could disincentivise them from seeking investors in the UK, potentially impacting the competitiveness of the UK's financial market.

In its report published in December 2021, HM Treasury confirmed that it intends to amend the definition of institutional investors to take certain unauthorised, non-UK AIFMs out of scope in line with industry feedback received. HM Treasury intends to take this change forward "at the appropriate time".

However, HM Treasury does not intend to amend the definition of institutional investor to exclude small authorised or registered AIFMs from scope. This is not a point it expressly consulted on in the call for evidence, though some respondents raised this issue in their responses and argued that small AIFMs should be excluded from scope. Nevertheless, HM Treasury indicated in its December report that it expects small AIFMs holding securitisation positions to be sophisticated entities capable of complying with relevant due diligence requirements and has not received any evidence that subjecting these entities to due diligence requirements disincentivises their participation in the securitisation market. As such, HM Treasury considers that small AIFMs should continue to be captured within the definition of institutional investor.

NPL Secondary Markets Directive impact on fund managers

Looking further ahead, EU Members States are required to apply the requirments of the new NPL Secondary Markets Directive which has now been published in the Official Journal of the EU, although its requirements need to be applied until 30 December 2023. Nevertheless, it is worth taking note of the changes expected to be introduced under the Directive now, in order to anticipate and plan for how these requirements may impact investors in secondary NPL transactions and the structuring of those transactions, including NPL securitisations.

The NPL Secondary Markets Directive will introduce new EU-wide requirements on the secondary purchase and servicing of NPLs originated by EU banks. In-scope credit servicers will require authorisation in order to carry on their servicing activities, but they will also benefit from a new passporting regime allowing them to scale up activities across the EU. In-scope credit purchasers will not require authorisation, but they will need to appoint an authorised credit servicer (or an EU bank or creditor that is subject to supervision under the EU Consumer Credit Directive or Mortgage Credit Directive) where they acquire consumer NPLs (or natural person or SME NPLs, in the case of non-EU credit purchasers). Non-EU credit purchasers will also need to appoint an EU representative that will be responsible for compliance with the requirements of the NPL Secondary

Markets Directive on behalf of the third country credit purchaser. This can be the same entity as their credit servicer.

Scope of the NPL Secondary Markets Directive

The NPL Secondary Markets Directive applies in respect of the secondary transfer of NPLs or the rights under NPLs originated by an EU bank to a transferee other than another EU bank (the "**credit purchaser**"). Transfers of performing loans are out of scope; for this purpose, NPLs are defined by reference to Article 47a CRR.[1] In addition, transfers of NPLs originated by entities other than EU banks are out of scope, although national rules and restrictions on transfers of such NPLs may apply.

The NPL Secondary Markets Directive also regulates "credit servicing activities", which it defines as the collection or recovery of payments from borrowers, renegotiating terms and conditions with borrowers, dealing with complaints and/or informing borrowers about changes to interest rates, charges or payments due. Legal entities that carry out these activities on behalf of credit purchasers in scope of the NPL Secondary Markets Directive will generally require authorisation as a credit servicer. (It is also open to EU Member States to allow credit purchaser to appoint natural persons to carrying on credit servicing activities, but they will not benefit from the EU-wide authorisation and passporting regime for credit servicers.)

However, the credit servicing requirements of the NPL Secondary Markets Directive do not apply to credit servicing activities carried out by EU credit institutions, authorised or registered AIFMs, UCITS management companies or entities that are subject to supervision in the relevant Member State under the EU Consumer Credit Directive or Mortgage Credit Directive. This means that EU AIFMs and UCITS management companies may themselves carry out credit servicing of NPL portfolios purchased by the funds they manage. However, MiFID portfolio managers or (other) delegates of an EU AIFM or UCITS management company do not benefit from a similar carve out from the scope of the NPL Secondary Markets Directive and so they would not be permitted to carry on credit servicing activities themselves (unless they were to obtain further authorisation as a credit servicer).

EU Member States can also continue to regulate other forms of credit servicing at national level, such as the servicing of loans originated by non-bank lenders.

While an exclusion from scope for NPL securitisations had been proposed during the negotiation process of the NPL Secondary Markets Directive, this is not included in the final text. Instead, there is a limited provision indicating that the NPL Secondary Markets Directive "shall not affect requirements in Member States' national laws" regarding credit servicing where the credit purchaser is a securitisation special purpose entity (as defined in the EUSR) provided that such national laws: (i) do not affect the level of consumer protection provided by the Directive; and (ii) ensure that competent authorities receive the necessary information from credit servicers. In practice, this means that most requirements of the NPL Secondary Markets Directive are expected to apply to NPL securitisations, with the exception of information requirements, as discussed below.

Information requirements for secondary transfers of NPLs and EBA templates

Where funds or other prospective purchasers are looking to purchase NPLs from an EU bank, the bank selling the NPLs will need to provide sufficient information (proportionate to the nature and size of the NPL portfolio being sold) to enable the proactive purchaser to diligence the relevant NPLs. The EBA is required to develop technical standards on the format in which this information is to be provided, in respect of in respect of any in-scope, subject to some transitional provisions for legacy loans. The EBA has already done significant work in this area, having published a Discussion Paper in May 2021, and will presumably use its existing templates as a base for the technical standards it has to develop under the NPL Secondary Markets Directive.

However, the recitals to the NPL Secondary Markets Directive indicate that where securitisation-related templates also need to be completed under the EUSR, double reporting of information should not be required under the NPL Secondary Markets Directive. Therefore, in practice, it is possible that most information for NPL securitisations would continue to be provided under the securitisation-specific templates, but this would require some further action (e.g. in the EBA's forthcoming technical standards) since there is no operative implementation of this principle in the NPL Secondary Markets Directive itself.

Appointment of a credit servicer – credit servicing agreement

Another new requirement under the NPL Secondary Markets Directive relates to the terms of appointment of a credit servicer. Where a fund or other credit purchaser

1 Capital Requirements Regulation (EU) No 575/2013

appoints a credit servicer to carry on credit servicing activities, the parties are required to enter into a credit servicing agreement. This agreement must include:

- a detailed description of the credit servicing activities to be carried out,
- terms on the credit servicer's remuneration,
- the extent to which the credit servicer can represent the credit purchaser in relation to the borrower,
- an undertaking by the parties to comply with applicable law relating to the credit agreement itself, including in respect of consumer and data protection,
- a clause requiring the fair and diligent treatment of borrowers, and
- a requirement for the credit servicer to notify the credit purchaser before outsourcing any of its credit servicing activities.

Other information and reporting requirements

The NPL Secondary Markets Directive includes various other information and reporting requirements. In particular:

- Following an NPL transfer, the credit purchaser or credit servicer (if one has been appointed) is required to inform the borrower(s) of the transfer, including the date of the transfer and identity of the credit purchaser (and if relevant the credit servicer). This information must be provided before the first debt collection and whenever the borrower requests it. This would represent a significant change from current market practice for NPL securitisations, where borrowers are often unaware that their loans have been transferred or securitised.
- EU banks and credit purchasers who onward-sell NPLs must supply data on their sales of NPLs to their regulators bi-annually (or quarterly if requested). This data must include details of the purchaser(s) and aggregated borrower data. If the NPLs include consumer loans, additional data must also be provided.

Next steps

The NPL Secondary Markets Directive was published in the Official Journal in December 2021. EU Member States have 24 months to transpose its requirements, which are due to apply from 30 December 2023. While the Directive seeks to harmonise certain key aspects of secondary NPL transfers and servicing, it also leaves various options and discretions to Member States, such as whether to regulate transfer and servicing of credit agreements that fall outside the scope of the Directive. Therefore, it will be important to monitor the way that Member States seek to transpose and implement these requirements.

Conclusion

After a few years of relative stability in the EU and UK regulatory landscape for asset managers engaging in securitisations, various new developments are now on the horizon. The clarifications to the scope of the institutional investor definition under the EUSR are unlikely to have a significant practical impact on firms, given that the ESAs Opinion appears to broadly accord with current industry interpretations. The potential narrowing of the territorial scope of the UK institutional investor definition should serve to reduce the overlap between UK and EU rules, which is likely to be welcomed in the post-Brexit context where firms are often left grappling with two sets of very similar (but not quite identical) rules.

The NPL Secondary Markets Directive will likely bring some implementation challenges for asset management firms, particularly if different Member States take different approaches to implementation or gold-plate its requirements where they are permitted to do so. New information and reporting requirements go beyond what is currently required under the Securitisation Regulation, although the increased burden is likely less extreme than for other types of secondary loan transfers, which are often unregulated today. Asset managers may also need to consider how best to navigate the credit servicer regime and related carve outs which apply to EU AIFMs and UCITS managers, but not to MiFID portfolio managers (although of course such considerations will fall away if the original lender continues to service the NPL portfolio in practice).

It will be interesting to see how the NPL securitisation market evolves to take account of the new NPL Secondary Markets Directive more broadly, for example whether existing specialist credit servicers seek to take advantage of the new passporting regime in order to provide their services throughout the EU. For further discussion of current market practice and emerging trends in NPL securitisations, including as a result of the NPL Secondary Markets Directive, see our separate article in this publication entitled "Non-performing loans: the evolving landscape".

SYNTHETIC SECURITISATIONS AND SRT

A key motivation for banks to execute synthetic securitisations is to reduce the amount of regulatory capital the bank is required to hold in respect of the underlying portfolio. Where the transaction satisfies the requirements for significant risk transfer under the Capital Requirements Regulation ("**CRR**"), the bank is able to substitute the pre-securitisation capital requirement for each underlying exposure with an aggregate capital calculation based on the securitised tranches. The requirement for each tranche will be based on the credit risk of that tranche, with the first loss tranche being viewed as high risk and the senior tranche receiving a significantly lower risk weight. By transferring the exposure to some or all of the riskiest tranches to investors, as is typically the case for synthetic securitisations, the reduction in regulatory capital for originators can be significant.

The existing provisions in relation to significant risk transfer are set out in Articles 244 and 245 of the CRR, and provide two different methods to achieve significant risk transfer: (i) the "mezzanine test", pursuant to which the originator retains not more than 50% of the risk-weighted exposure amounts of all mezzanine tranches in the securitisation, and (ii) the "first loss test", whereby the originator holds not more than 20% of the exposure value of the first loss tranche in the securitisation, subject to (A) the originator demonstrating that the exposure value of the first loss tranche exceeds a reasoned estimate of the expected loss on the underlying exposures by a substantial margin, and (B) there not being any mezzanine securitisation position. These are often referred to as the "mechanistic tests". In addition to the mechanistic tests, it is also necessary for the bank to show that the reduction in the risk-weighted exposure amounts which would be achieved by the securitisation is justified by a commensurate transfer of credit risk to the investors, and for the securitisation to comply with a number of other structural requirements.

However, the existing regime has been subject to market criticism for being insufficiently precise and prescriptive, with some elements (such as the commensurate risk transfer test) being vague and with little guidance on what constitutes mandatory versus permitted versus disqualifying features. As a result, competent authorities have been left with wide discretion and the unenviable task of interpreting the rules, which has led to varying approaches being taken across different European jurisdictions. These local interpretations have also shifted over time, compounding the uncertainty faced by originators. In a market which is inherently private, this has left many banks to rely on a patchwork of precedents, guidelines and market knowhow when attempting to predict how their transactions and key structural features will be treated.

The EBA Report

On 23 November 2020, the EBA published its much anticipated report on significant risk transfer in securitisation (the "**EBA Report**"). The EBA Report focusses on three main areas of significant risk transfer where inconsistencies were found, and in relation to which the EBA determined that greater harmonisation of both supervisory practices and structuring processes would markedly contribute to enhancing the efficiency and consistency of supervisory assessments within the current framework. These are: (i) structural features of securitisation transactions; (ii) significant risk transfer tests; and (iii) the significant risk transfer assessment process and standard documentation.

Amongst other things, the EBA Report attempts to plug some of the gaps in Article 245 of CRR by providing more detailed guidance to the relevant competent authorities as to how structural features should be assessed, with the aim of creating more consistency in the synthetic securitisation market across different EU jurisdictions. It does so by (i) setting out certain structural features the inclusion of which would disqualify a transaction from achieving significant risk transfer, (ii) listing certain structural features which will require additional safeguards to be put in place in order for significant risk transfer to be recognised, and (iii) requiring originators to submit a quantitative analysis on the various structural features to the competent authority as part of its risk transfer assessment.

Whilst this article does not seek to summarise all the recommendations made in the EBA report, of particular interest to synthetic securitisations are:

1. *Pro rata amortisation* – The EBA recommendations in relation to pro rata amortisation clarify what has to date been a somewhat murky area with inconsistent approaches taken by both banks and regulators. This includes deals with "pro rata for life", "pro rata switch to sequential" and "sequential only" transactions, all of which can currently be found in the market. The EBA suggests that pro rata amortisation should not of itself be a barrier to achieving significant risk transfer, however, certain backwards- and forward-looking triggers should be in place to switch the amortisation mechanics to sequential if the portfolio deteriorates or does not perform as well as expected at inception. From a structuring perspective, this will grant banks the flexibility to use pro rata where appropriate, and the triggers should give the regulators comfort that the junior tranches will not be over-amortised (and that the protection will remain in place) in stressed scenarios.
2. *Time calls* – The EBA recommends that time calls which satisfy the requirements set out in the report (which are broadly in line with the current use of time calls in synthetic securitisations), should not be seen as hindering the achievement of significant risk transfer. Time calls have, together with pro rata amortisation, been seen as one of the main divisive features in the market, with some regulators declining to approve transactions with time calls, or requiring the bank to treat the earliest call date as the scheduled maturity of the securitisation, with the resulting maturity mismatch causing the transaction to be economically unviable. A uniform approach to time calls would be a welcome change, and would allow originators to include time calls where appropriate without jeopardising the significant risk transfer or capital treatment of the transaction.
3. *Regulatory calls* – Whilst regulatory calls are common and generally uncontested in the synthetic securitisation market, the EBA Report somewhat expanded the scope by including reference to "relevant taxation and accounting provisions". Accounting provisions in particular are typically not included in the regulatory call (whereas tax tends to be covered in a separate termination event), and it will be interesting to see if this is something that becomes more common going forward.

The EBA Report also contains a review of the mechanistic tests and the commensurate risk transfer test. In relation to the mechanistic tests, the EBA noted that, in contrast to the mezzanine test, where the amount of risk required to be transferred is objectively defined as 50% of the risk-weighted amounts of all mezzanine tranches in the securitisation, the first loss test merely refers to the thickness of the first loss tranche exceeding the expected loss on the vagary, the EBA recommended that the first loss tranche should have a minimum thickness which is sufficient to absorb the lifetime expected losses (EL) and two-thirds of the unexpected losses (UL) on the underlying portfolio (after taking into account the portion of EL and UL which is expected to be covered by synthetic excess spread, where relevant).

More complex were the recommendations on the commensurate risk transfer test. Again, the EBA noted that the CRR itself does not provide any objective rules for how this is to be assessed, which has created a lot of uncertainty in the market. In an attempt to address this, the EBA proposed two objective tests, the "principles based approach test" (or PBA test) and the "CRT test". The PBA test looks at the percentage of the regulatory UL transferred to investors to the regulatory UL on the underlying portfolio, and requires that to be at least equal to 50%. In contrast, the CRT test looks requires that the percentage of the capital saved by the originator is less than or equal to the percentage of the lifetime EL and UL transferred to investors. Again, in calculating both these tests, the originator should adjust the amount of risk transferred after taking into account any losses expected to be absorbed by synthetic excess spread.

It is interesting that the EBA has sought to provide greater certainty on the application of the commensurate risk transfer test by turning it from a more subjective test into a more objective one. One risk of this is that it will create inconsistent outcomes is some cases, where inherently riskier transactions might pass the test while more conservative transactions could fail. The EBA recognised this risk, but nevertheless has clearly determined that the benefits of certainty for the majority of transactions is to be preferred for the market as a whole.

For the time being these tests remain just recommendations, and while banks are certainly having regard to them in structuring transactions, they do not currently have force of law. Nevertheless, it will be interesting to see what impact these proposals will have on the market in the coming months.

In addition to the specific criteria for significant risk transfer, the EBA Report also addresses the notification process itself, which has been criticised for being opaque and lacking uniformity between the different regulators. The notification procedures vary significantly between different regulators, ranging from a pre-notification and formal notification combination, with the approval being provided pre-closing, to a no-objection letter post-closing, or indeed, no feedback at all. This is further muddled by the fact that the information required by the approval process often differs, with a basic term sheet at one end of the scale to near final documentation with detailed modelling at the other.

The EBA Report seeks to remedy some of these points by recommending that (i) a formal notification framework be established requiring *ex ante* notification by the originator of the significant risk transfer transaction at the latest 1 month prior to the expected issuance, with pre-defined information/documentation forming part of the submission and (ii) the competent authority should provide explicit point-in-time feedback to the originator on whether significant risk transfer has been achieved, including, as applicable, by way of a statement of no-objection or objection by a pre-set deadline.

Increased visibility on the timing, scope and requirements for the notification and ongoing approval process would greatly assist the originators in managing both internal processes and the transaction timeline generally, and would provide more clarity and certainty for all parties involved.

Next steps

The EBA Report was prepared in accordance with the mandate laid down in Articles 244(6) and 245(6) of the CRR, which also gives the Commission the power to adopt a delegated act in accordance with Article 462 to supplement the CRR, taking into account the recommendations laid down by the EBA in the EBA Report. While it is expected that the Commission will ultimately adopt a number of the recommendations laid down in the EBA Report, it is not clear at this time whether this will indeed be by way of a delegated act, or whether the Commission will choose to roll these reforms into the broader review of the Securitisation Regulation and Securitisation Framework in the CRR which is currently underway. For more detailed discussion of this broader review, please see our separate article in this publication entitled “The Future of the Securitisation Regulations in the EU and UK: Brexit and beyond”.

The EBA Report also includes some recommendations that the EBA views as being more appropriately laid out in another legal instrument such as EBA Guideline, as well as recommendations that would require further amendments to the CRR itself, and that are therefore outside the scope of a delegated act under Articles 244(6) and 245(6). One of these proposals, to require originators to hold capital against synthetic excess spread, has actually already been implemented as part of the Capital Market Recovery Package which entered into force in April 2021 (although the requirement to hold capital against synthetic excess spread will itself not take effect until April 2022, and the precise requirements are yet to be clarified in regulatory technical standards). Again, some of the other recommendations may be adopted as part of the current review of the Securitisation Framework.

STS FOR SYNTHETICS: A LONG JOURNEY FINALLY NEARING COMPLETION

In April 2021, the EU Securitisation Regulation (the "**EUSR**") and the Capital Requirements Regulation (the "**CRR**") were amended as part of the securitisation Capital Markets Recovery Package (the "**CMRP**"), intended to help the EU's economy recover from the impact of Covid-19. The CMRP included some long-awaited amendments to the EUSR which provide for a comprehensive "simple, transparent and standardised" ("**STS**") framework for balance sheet synthetic securitisations in the EU. This article discusses the history of the synthetic STS framework introduced by the CMRP, provides an overview of the STS criteria now applicable to balance sheet synthetic securitisation and a discussion of the benefits of the regime.

The history

When the EUSR was introduced at the end of 2017, it included an STS framework for traditional securitisations in the EU. Synthetic securitisation was excluded from this regime, as it was from the corresponding "STC" securitisation framework set out by the Basel Committee on Banking Supervision.

Although synthetic securitisation was excluded from the original STS framework, Article 45 of the EUSR contained a requirement for the European Banking Authority ("**EBA**") to publish a report on the feasibility of extending the STS framework to synthetic securitisation so as to enable to the European Commission to consider whether to prepare a legislative proposal to that effect.

On 6 May 2020, the EBA published this report (the "**2020 Report**"). The 2020 Report was the culmination of a series of papers released by the EBA over the preceding few years, beginning with the EBA Report on Synthetic Securitisation in December 2015 (the "**2015 Discussion Paper**"), in which the EBA first proposed a set of potential STS criteria which could apply to synthetic securitisation. In that report, the EBA also recommended that the differentiated capital treatment which applies to traditional STS securitisation be extended to some SME synthetic securitisations, a recommendation which was adopted in Article 270 of the CRR and began to apply at the same time as the EUSR on 1 January 2019.

The 2020 Report was also preceded by a discussion paper released by the EBA in September 2019 (the "**2019 Discussion Paper**") and the 2020 Report takes into account responses received from stakeholders during the two-month consultation period that followed the publication of the 2019 Discussion Paper. In the 2020 Report, the EBA discussed the way in which the balance sheet synthetic securitisation market had grown over the preceding 10 years, such that it was then being used by a large number of banks across the EU as part of their credit risk and capital management strategies.

In particular, the EBA analysed the performance of synthetic securitisations, observing that there had been very low loss rates across all asset classes. The EBA also recognised in the report that synthetic securitisation had an important role to play in enabling banks to manage their credit and capital requirements for exposures which are not well-suited to traditional securitisation, either because of the nature of the exposures (such as large revolving corporate loans) or because of issues which may prevent achieving a true sale (such as the geographic spread of the exposures or confidentiality concerns).

Finally, the EBA emphasised how the enhanced regulatory environment which by 2020 applied to all EU securitisations under the EUSR has gone a long way to redressing what had previously been perceived as concerns with synthetic securitisation.

Based on the analysis conducted, the EBA recommended that it was appropriate to extend the STS framework to include balance sheet synthetic securitisation. This recommendation was picked up by the European Commission when it proposed the CMRP, which closely follows the proposals set out by the EBA in the 2020 Report.

The market has been quick to start implementing the new regime, and we have now closed several synthetic STS securitisations.

Overview of the STS criteria

The STS criteria for synthetic securitisations introduced as part of the CMRP amendments are modelled closely on the criteria for traditional STS securitisation already set out in the EUSR so as to ensure as much consistency across the "STS" label as possible. However, some of the traditional STS criteria which cannot be applied to synthetic securitisation (such as the requirement for a true sale, or hedging of interest and currency risk) are excluded or modified.

At the same time, some additional criteria are included to reflect features of synthetic securitisation which do not arise in traditional securitisation. These include requirements to mitigate the counterparty credit risk that is inherently involved in synthetic securitisations, requirements addressing various structural features such as the scope of credit events and methods for calculating loss payments, and, perhaps most importantly, requirements ensuring that the framework only applies to balance sheet synthetic securitisation, and not to arbitrage synthetic securitisation.

Specific criteria

The CMRP amendments to the EUSR inserted a new section setting out the STS requirements specific to on-balance-sheet synthetic securitisations. This section includes general requirements, requirements relating to simplicity, to standardisation, to transparency, and finally requirements concerning the credit protection agreement, the third-party verification agent and synthetic excess spread.

Articles 26b to 26d (the requirements for simplicity, for standardisation and for transparency) contain very similar criteria to those that apply to true sale securitisation, whereas Article 26e (the requirements concerning the credit protection agreement, the third-party verification agent and synthetic excess spread) includes specific criteria reflecting the nature of synthetic securitisation.

Article 26b (Requirements relating to simplicity)

The key criteria in Article 26b are as follows:

- the originator may not double hedge its exposure to the credit risk of the underlying exposures (Article 26b(4));
- the originator is required to provide certain representations in respect of the underlying exposures (Article 26b(6);
- the securitisation must be backed by a pool of underlying exposures that are homogenous in terms of asset type (Article 26b(8));
- the underlying exposures must have defined payment streams (Article 26b(8));
- the underwriting standards pursuant to which the underlying exposures are originated and any material changes from any prior underwriting standards must be fully disclosed to potential investors without undue delay (Article 26b(10); and
- debtors must, at the time of the inclusion of the underlying exposures, have made at least one payment (subject to two carve-outs) (Article 26b(12)).

Article 26c (Requirements relating to standardisation)

The key criteria in Article 26c are as follows:

- pro-rata amortisation is permitted if certain specified triggers are included, following which amortisation switches to sequential amortisation (Article 26c(5)); and
- a replenishment period may be included if certain specified triggers are included for the termination of the replenishment period (Article 26c(6)).

Article 26d (Requirements relating to transparency)

The key criteria in Article 26d are as follows:

- the originator must make available data on static and dynamic historical default and loss performance such as delinquency and default data, for substantially similar exposures to those being securitised, to potential investors, covering a period of at least five years (Article 26d(1));
- a sample of the underlying exposures must be subject to external verification prior to closing by an independent third party (Article 26d(2)); and
- prior to pricing, the originator must make available to potential investors a liability cash flow model and must, after pricing, make that model available to investors on an ongoing basis and to potential investors on request (Article 26d(3)).

Article 26e (Requirements concerning the credit protection agreement, the third-party verification agent and the synthetic excess spread)

The key criteria in Article 26e are as follows:

- an initial loss payment must be made in respect of an underlying exposure at the latest six months after the occurrence of a credit event (Article 26e(2));
- the initial loss payment must be at least the higher of (i) the expected loss amount that is equivalent to the impairment recorded by the originator in its financial statements and (ii) the expected loss amount determined in

accordance with the relevant CRR rules[1] (Article 26e(2));

- the maximum workout period for an underlying exposure following the occurrence of a credit event is two years (Article 26e(3));
- at the end of the workout period, the final loss payment must be made on the basis of the originator's final loss estimate that would have been recorded by the originator in its financial statements at that time (Article 26e(3));
- a third party verification agent must be appointed prior to closing, who must verify at least the specified requirements in respect of each underlying exposure that suffers a credit event (Article 26e(4));
- the third party verification agent may perform the verification on a sample basis, but investors must be able to request verification of the eligibility of any individual underlying exposure where they are not satisfied with the sample-based verification (Article 26e(4));
- the originator may not terminate the transaction for any reason other than (i) the insolvency of the investor, (ii) the investor's failure to pay any amounts due under the credit protection agreement or a breach by the investor of any material obligation, (iii) relevant regulatory events, (iv) following the exercise of a time call, (v) following the exercise of a clean-up call and (vi) in the case of unfunded credit protection, the investor no longer qualifies as an eligible protection provider (Article 26e(5));
- investors may not terminate the a transaction prior to its scheduled maturity for any reason other than a failure to pay the credit protection premium or any other material breach of contractual obligations of the originator (Article 26e(5));
- the transaction may utilise synthetic excess spread where certain specified criteria are met (Article 26e(7));
- unfunded protection may only be provided by counterparties eligible for a zero per cent risk weight under the CRR (Article 26e(8));
- in the case of a funded transaction, both the investor and originator must have recourse to high-quality collateral in the form of (i) zero weighted debt securities under the CRR (which must have a maturity no later than the next payment date under the transaction and must be held by a third party custodian) or (ii) cash held with the originator or a third party institution, each of which must have a credit quality step ("**CQS**") rating of 3 or above (Article 26e(10)); and
- the collateral requirements are deemed to be satisfied in the case of transactions structured as direct CLN issuances by the originator (Article 26e(10)).

Points of interest

Relationship with significant risk transfer requirements

Given that many synthetic securitisations are executed at least partly for the purpose of achieving significant risk transfer ("**SRT**"), it was always important that the STS criteria were not inconsistent with the SRT requirements. At the same time, the STS framework was always intended as being primarily for the benefit of investors, and thus at least notionally in tension with the promotion of significant risk transfer, thus requiring some nuance in formulating a framework for synthetic STS securitisation. In the end, although the STS criteria remain separate from the SRT requirements, there is a lot of overlap between the two sets of rules, and a number of the STS criteria set out in Article 26e actually appear to have been based on the requirements for SRT.

Originator-friendly requirements

Consequently, not all of the criteria set out in Article 26e are beneficial to investors. For example, investors' early termination rights are significantly restricted under the STS regime for synthetics. This is a result of the EBA, in the 2020 Report, noting that one of the drivers for synthetic securitisation is credit risk mitigation, and as such the framework had to be designed to take account of the significant originator interests in the securitisation.

Collateral requirements

As noted above, collateral in respect of funded transactions must either be in the form of zero risk weighted securities (effectively government bonds) held by a third-party custodian or in the form of cash held with the originator or a third-party account bank (each of which must be rated CQS 3 or better). The CQS 3 rating is proving particularly difficult for originators, many of whom have a credit rating below CQS 3, meaning that cash collateral must be held with a third-party account bank, thereby significantly weakening the capital savings achieved by the transaction.

Homogeneity requirements

Pursuant to Article 26b(13), the EBA is required to submit draft regulatory technical standards in relation to the homogeneity requirement in Article 26b(8) to the Commission by 10 October 2021. Despite this, the regulatory technical standards have not yet been published and until such time as they are, there remains significant uncertainty surrounding the homogeneity requirements. This is the

1 The rules are set out in Chapter 3 (*Internal ratings based approach*) of Title II (*Capital requirements for credit risk*) of Part Three (*Capital requirements*) of the CRR.

key criterion that will be subject to further development.

Who benefits?

The benefits of STS compliance consist of a reduction in the p-factor and the risk-weight floor applicable to the senior tranche retained by the originator in the same way as for a traditional STS securitisation.

However, unlike the position for traditional STS securitisation, the differentiated regulatory capital treatment applicable to STS balance sheet synthetic securitisations applies only to the most senior tranche in the synthetic securitisation and is only available to the originator. This is in contrast to true sale securitisations, where the regulatory capital benefits are available to any holder of any position in the securitisation. As a result, investors in synthetic securitisations are generally less concerned about the STS label and STS compliance is driven by the originator.

Conclusion

After several years in the making, the STS regime for synthetic securitisations has come into force in the EU. Given the benefits of STS compliance for originators, we have seen great interest in STS compliance when structuring transactions, and we have now closed several STS-compliant transactions. Nonetheless, the journey is not yet complete, as the market awaits regulatory guidance on the interpretation of several criteria, most notably the homogeneity requirement.

US DEVELOPMENTS IN THE CRT MARKET: GROWING OPPORTUNITIES

The credit-risk transfer ("**CRT**") market in the US continues to expand, with new banks and new asset classes. Several of the largest US banks have been active in this market and have recently increased sales of risk-transfer securities tied to mortgages, corporate loans and auto loans. Most recently, the issuance of CRT notes linked to mortgage warehouse lines by two regional banks – Texas Capital and Western Alliance – has attracted significant attention and speculation on whether other regional banks will follow suit.[1] This continued development and growth of the market has market participants asking: what does the future of the CRT market look like?

The answer to this question and the future development and growth of the market depends on two factors: first, recognition of CRT for regulatory capital ("**reg cap**") purposes in the US, and second, market familiarity and comfort with the different structures that are available. This article describes the following considerations which may affect the regulatory recognition of CRT and the expansion of the CRT market: first, the basic regulatory issues, second, the structuring considerations and third, and the legal issues that are raised. While several CRT transaction structures are possible, this article focuses on CRT notes.

Regulation of CRT transactions

The US reg cap rules that determine the impact of CRT are set out in Regulation Q[2], issued by the Board of Governors of the Federal Reserve System ("**Federal Reserve**"), and very similar rules issued by other federal bank regulators. The Federal Reserve's view is critical to the growth and development of the CRT market because the Federal Reserve regulates bank holding companies, and essentially all significant banks are subsidiaries of bank holding companies. The Office of the Comptroller of the Currency, which regulates national banks, and other federal regulators are also involved in the relevant analysis.

The reg cap rules do not require banks to get regulatory approval before recognising the capital benefit of a CRT transaction. Nonetheless, most banks discuss CRT transactions with their regulators in order to get some comfort that the reg cap benefits will not be disallowed after the issuance of CRT notes.

Bank issuers get reg cap relief if a CRT transaction qualifies as a "synthetic securitisation" and meets certain other operational criteria for synthetic securitisations set under Regulation Q. In order to meet the Regulation Q definition of a "synthetic securitisation", a CRT transaction must transfer credit risk on a reference pool of financial assets through derivatives (which are viewed by the market as including credit-linked notes) into multiple tranches. In addition, the synthetic securitisation must have a credit risk mitigant, which can include cash collateral. For CRT notes in the form of credit-linked notes, the cash proceeds of the notes are viewed as cash collateral.

The rules also require that any "clean-up call" must be limited to an eligible clean-up call, which is exercisable only when 10% of the reference pool remains outstanding. Because "clean-up call" is not clearly defined under Regulation Q, this requirement has been the subject of some discussion about which discretionary calls by an issuer are permitted. In practice, CRT notes typically include a call right by the issuer if the regulators prevent the issuer from recognising the capital benefits of the notes. This mirrors the position in the European market, where regulatory calls are standard and included in most deals, in addition to the clean-up calls and, in some jurisdictions, time calls.

If the CRT transaction qualifies as an appropriate synthetic securitisation, it can achieve reg cap reduction for the issuer. The amount of the reg cap reduction will depend on the nature of the assets in the reference pool, the nature of the collateral (cash for credit-linked notes), and the attachment and detachment points for the credit protection. Typically, reg cap relief will only be achieved if the relevant collateral is subject to a collateral agreement for at least the life of the

1 See, for example, the Wall Street Journal article "Hot Housing Market Lets Bank Sell Mortgage Risk" July 29, 2021, https://www.wsj.com/articles/hot-housing-market-lets-banks-sell-mortgage-risk-11627464600.

2 Federal Reserve Board, *Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks*, 12 C.F.R. Part 217 (2015) ("**Regulation Q**").

financial asset for which reg cap relief is obtained.

There is a possibility that the regulators may take a more formal, public position on the issuance of CRT notes in the future which may provide additional comfort to potential market participants, but as of yet they have not done so. There has also not been any indication to date that the Biden administration has a particular view favouring or disfavouring CRT notes.

Key structural considerations

Form of CRT

While this article focuses on CRT notes, several structures may be utilised for a CRT transaction, including CRT notes and unfunded credit derivatives swaps ("**CDS**"). In order to achieve reg cap relief, unfunded CDS needs collateral arrangements or a specialised counterparty.

All US CRT notes issued in the past year have been credit-linked notes directly issued by the bank. The terms of the credit-linked notes provide that the principal amount of the notes will be written down by credit losses suffered on the reference pool. The effect of this write-down feature is to transfer credit risk from the bank to the noteholders. These credit-linked notes are relatively simple in that they are typically unsecured obligations of the bank itself. There is usually no swap or segregated collateral. One consequence, and possible down-side, of this structure is that noteholders are exposed to the credit risk of the bank as well as credit risk on the reference pool.

Other CRT note structures are possible: for example, banks have considered establishing an SPV that could issue notes and then enter into a collateralised credit derivative or other risk transfer instrument with the bank. This SPV structure has the advantage of insulating the noteholder from the credit risk of the bank, and has for many years been a regular feature in the European market, where banks have historically used SPV structures to offer investors portfolio risk without bank risk, using either cash at bank or liquid securities with a third party custodian as collateral. However, the SPV introduces significant complexity because it requires a swap and collateral arrangements. These arrangements, in turn, cause greater regulatory complexity because the swap is potentially subject to swap regulation and the SPV is potentially subject to specialised rules (such as the Investment Company Act or commodity pool rules) applicable to SPV issuers.

Given the simplicity of the credit-linked note structure, we expect that CRT notes in the form of credit-linked notes directly issued by banks will continue to be the most frequently used structure for CRT transactions in the US markets. This mirrors the trend in the European market where a number of banks have turned, at least in part, to credit linked notes rather than SPV structures, and investors are increasingly getting comfortable with investing on this basis.

Asset pool

The reference pool underlying a US CRT transaction can be composed theoretically of any type of financial asset. In practice, the reference pool is constrained by the following limitations: the asset should have a relatively high capital cost; and the asset should have a term that is no longer than the term of a CRT that investors are willing to buy. For US transactions to date, assets have included corporate loans, fund financing, auto loans or mortgage warehouse loans. For future CRT transactions, the most attractive classes are those that combine a relatively high capital cost with relatively low default rates (such as mortgage warehouse loans), because the capital cost will maximise the capital benefit to the bank while the low default rate will make the CRT more attractive to investors. By comparison, there has in recent years been a diversification in the portfolios used in the European market, including derivatives, green financing, SME, and housing loans, and it remains to be seen whether transactions in the US market will similarly expand to include a wider range of portfolios.

An additional issue related to the asset pool is whether it is static or dynamic. A dynamic pool enables the bank issuer to put new assets in the reference pool as old assets run off. It will however require the bank to establish criteria for new assets to give reassurance to the investor about the quality of the assets in the pool. Typically, dynamic pools are structured so that there is a "replenishment period", during which the bank can add new assets as the old ones pay off; and then an "amortisation period", during which the CRT notes can pay down but no new assets can be added to the pool. This is the structure typically used in European deals, where the vast majority of transactions are replenishing, with either sequential or pro-rata amortisation following the replenishment period.

Risk retention

Under US law, as described further below, risk retention rules do not apply to the bank issuer. EU or UK rules may apply, however, if CRT notes are sold into those jurisdictions. As a commercial matter, some investors may require that the bank retain some portion of the reference pool on an un-hedged basis.

Legal, disclosure, and tax considerations

Not a securitisation

Credit-linked notes issued directly by banks are not viewed as "asset-backed securities" under US securities laws, because the cash flow to pay the notes comes from the bank rather than the assets in the reference pool. As a result, the credit-linked notes are not subject to US risk retention requirements or other requirements applicable to asset-backed securities.

US sales

CRT notes are generally sold to US investors in private placements. Because they are sold directly by the bank to a limited number of investors, and because they do not fit the typical risk profile of bank securities, they are typically sold under Rule 4(a)(2) of the Securities Act. The bank issuer will usually require consent by the investors for any secondary sale of the CRT Note, and this restriction supports the Rule 4(a)(2) analysis.

Swap

As discussed above, the credit-linked note structure does not involve a swap so the swap regulations will not apply. As discussed above, the SPV structure does raise swap regulatory issues, and addressing those issues will depend on the specifics of the transaction.

Disclosure

Many CRT deals do not have an offering document but instead rely on investor diligence. Such diligence will require the bank issuer to set up some form of data room for the investor to review the relevant reference pool. A full disclosure document would need to describe the reference pool and the process used by the bank to originate or select the assets, which can be challenging to prepare.

US tax

Because the CRT notes may be written down by an amount tied to the bank's losses, the CRT notes may potentially be viewed as a guarantee for US tax purposes. This characterisation causes potential tax withholding problems for CRT notes sold outside the US if the reference pool includes loans to US borrowers. There are different approaches to dealing with this tax issue which will depend on the location and default rates of the reference pool, the location of noteholders and other factors.

Conclusion: what does the future of the CRT market look like?

So long as the regulators do not take an adverse position on the issuance of CRT notes, we expect that the CRT market in the US will continue to grow. We expect that CRT notes in the form of credit-linked notes directly issued by banks will continue to be the most frequently utilised structure for CRT transactions, with new banks utilising this structure to enter into CRT transactions and expand the CRT market.

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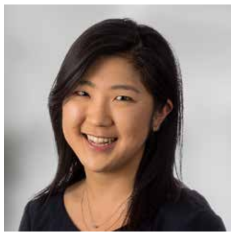

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