C L I F F O R D

C H A N C E

SECURITISATION MARKETS AND REGULATION: CHOOSING DIFFERENT PATHS?

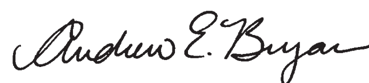
FOREWORD

Another year of change in the securitisation markets draws to a close with the anticipation that there will be further significant changes, particularly in regulation, over the next year. In the regulatory space, this may lead to some meaningful divergence in how the EU and UK approach regulation of securitisation even if the basic substantive structure of the rules is likely to continue to align. However, change is not limited to regulation: we have seen the mix of issuance affected by bumpy periods that mainly affect public ABS markets, while private securitisation financing has been more constant. New issuers have entered the market – particularly new specialty finance companies – and have secured financing of their product offerings which often contain innovative features. Not surprisingly given that, the market for esoteric securitisations has often been vibrant over the last year: another trend we expect to continue. In short, securitisation has continued to be a rich and diverse landscape and there is no sign of that changing!

Securitisation has not, however, been immune from macro events affecting the capital markets. The financial risks of Covid-19 may be losing prominence but there is still a war in Ukraine and most European economies (including the UK) as well as the United States are having to adjust to a period of high inflation – and corresponding interest rate rises. Moreover, bank failures and rescues have caused issuance and related activity to pause at times. The securitisation markets have nevertheless, on the whole, remained robust in the face of these challenges; but inevitably volatility will remain a fact of life.

Looking forward, we hope that the high level of engagement by policymakers and regulators and the oft-stated policy goal of securitisation being an important component of the EU and UK capital markets will lead to tangible steps being taken to encourage both issuers, through better-calibrated obligations, and investors, through better-focussed diligence requirements, to enter into and deepen the market for securitisation.

Kevin Ingram
Partner, on behalf of the
International Structured Debt Group



Andrew E. Bryan
Knowledge Director – Structured,
Asset-Backed and Real Estate Finance

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ESAs JOINT ADVICE: A FALSE DAWN FOR THE EUROPEAN SECURITISATION PRUDENTIAL FRAMEWORK?

Contributors: Precious Ivongbe, Kevin Ingram

On 12 December 2022, the European Supervisory Authorities ("**ESAs**") provided a set of joint advice to the Commission about the prudential frameworks for securitisation applicable to banks and insurers. In their response, the ESAs recommended limited changes to the framework for banks and no changes to the framework for insurers. This article considers that advice, the direction of travel for those prudential frameworks and the potential impact on securitisation in Europe.

Key Issues

- ESAs took the view that prudential requirements on banks and (re)insurers have limited impact on growth of EU securitisation markets.
- Proposals by ESAs for meaningful reform to bank prudential requirements are impractical because they require going to Basel, meaning they would be delayed several years at best.
- Industry stakeholders disappointed no change was proposed to prudential requirements for (re)insurers despite evidence supporting recalibration of these capital requirements.
- There is some scope for changes despite the ESAs' unambitious report, but this likely requires significant industry support.

Background

The ESAs' joint advice on the review of the securitisation prudential framework applicable to banks and insurance companies (the "**JA**") was provided in response to a European Commission Call for Advice dated October 2021. The Commission were aiming to identify possible ways of reviving the EU securitisation market on a prudent basis.

This desire to revive the securitisation market comes in the context of low participation relative to the levels prior to the global financial crisis of 2008, and also relative to current levels of activity in the US securitisation market. For instance, the ESAs (consisting of the European Securities & Markets Authority, the European Insurance & Occupational Pensions Authority ("**EIOPA**") and the European Banking Authority) noted that the gap between the EU market for public securitisations and its US counterpart has widened significantly in recent years - while the public EU market has experienced an 8% decline in terms of outstanding balances in the last five years, its US counterpart has grown by 11% within the same period. A lack of data means no equivalent comparison for private markets was possible.[1]

Among other things, the Commission asked the ESAs to consider:

(i) the application and impact of the key parameters for the calculation of risk-weighted exposure amounts for securitisation positions in relation to banks;

(ii) the impact of the existing parameters for the calculation of capital requirements on the spread risk for securitisation positions on the behaviour of (re)insurers;

(iii) the impact of the securitisation capital framework on banks' origination and investment activity;

(iv) whether the Solvency II capital framework has been a significant driver for (re)insurance companies' investment activity in EU securitisation markets in recent years; and

(v) whether other factors, including regulatory rules other than capital requirements, should be regarded as having a major impact.

We consider the ESAs' response relating to banks and (re)insurers below.

The Banking Sector

Capital requirements

The ESAs considered the impact of existing prudential requirements on banks' securitisation activity and took the view that a recalibration of the securitisation prudential framework for banks, without more, would not be sufficient to revive the EU securitisation market. However, they acknowledged that some positive trends exist to show that the bank capital framework may play a more important role in the significant risk transfer ("**SRT**") market, as compared to the wider securitisation market.

1 https://www.eiopa.europa.eu/system/files/2022-12/jc_2022_66_-_jc_advice_on_the_review_of_the_securitisation_prudential_framework_-_banking.pdf

In their view, the prevailing low growth in EU ABS markets is attributable to low interest by investors and originators, and not to regulatory capital requirements. On the demand side, investors are discouraged from investing in ABS assets due to complex and extensive regulatory due diligence requirements. These impose an assessment premium in the form of high due diligence costs not imposed on comparable investments such as covered bonds. On the supply side, the limited investor base as well as access to alternative sources of funding from more familiar (and less complex) sources have also discouraged originators' participation.

The ESAs therefore made the following recommendations with respect to the prudential framework for banks:

- Technical fixes to improve the clarity and consistency of the existing prudential framework (without a significant deviation from the underlying logic of the Basel framework).
- Improving the risk sensitivity of the securitisation framework by recognising the reduced model and agency risk associated with originators retaining senior securitisation tranches (mainly relevant to synthetic SRT deals).
- Liaising with the Basel Committee on Banking Supervision on more substantial reforms on the securitisation risk weight formulas.

By way of background, in setting risk weights for bank securitisation exposures, the Basel Committee considered the agency risks (arising from the multiple relationships between the agents in a securitisation structure) and model risks (arising from assumptions made on the underlying pool which is used to estimate loss distribution) associated with securitisations. This led to the adoption of a stricter prudential approach (compared to directly held exposures) to control for the agency and model risks via non-neutrality correction factors, i.e. the "p" factor and the risk weight floor. The "p" factor refers to a capital surcharge on securitisation tranches relative to the capital charge on the underlying pool.[2]

In adopting the non-neutrality correction factors, the Basel Committee however failed to make a distinction between circumstances where senior tranches of securitisations are retained and where they are not, even though the risks are clearly lower in securitisation transactions where senior tranches are retained by the originator such as SRT transactions.

Although the recommendation to reduce the risk weight floor applicable to senior tranches of securitisation retained by originators represents a departure from the Basel methodology, this recommendation appears to be a step in the right direction particularly as it seems economically inefficient to require originators who hold positions in the senior tranches of their own securitisations to maintain high capital buffers for agency and model risks. However, the ESAs acknowledged that implementing this recommendation should be accompanied by an appropriate set of safeguards.

On the other hand, it is not clear why the ESAs have not extended their recommendation to include a reduction of the "p" factor, as they have done for the risk weight floors. This is particularly noteworthy as industry participants have previously expressed the view that they consider the "p" factor to be punitive. Indeed, there is a compelling argument to reduce this factor to reflect reduced agency and model risks associated with senior tranches of securitisations which are retained by originators – as is the case for most SRT transactions.

Criticisms of the calibration of the "p" factor are not limited to industry. A broad range of stakeholders in the EU's High-level Forum on the Capital Markets Union have called for a reduction of the "p" factor across securitisations on the basis that the introduction of the STS framework has addressed some of the agency risks which the "p" factor corrects for. In addition, a recalibration of the "p" factor would also serve to maximise the effect of the reduction in the risk weight floors on retained senior tranches, which is a recommendation of the JA.

It is noteworthy that although not proposed by the ESAs, temporary amendments to the "p" factor have been proposed by the European Parliament as part of its negotiating position going into trilogues on the amendments to the Capital Requirements Regulation. These amendments are proposed to be in place as a transitional arrangement pending the completion of the "securitisation comprehensive review", an essential element of the Capital Markets Union Action Plan. It is proposed that the "p" factor would be halved for the purpose of the calculation of the output floor, in order to mitigate the unintended impact of the output floor calculation which limits the amount of capital benefits a bank can obtain from using its internal risk models rather than the standardised risk models. The proposal for reform was justified on the basis that the existing highly conservative calibration of the SEC-SA (securitisation standard approach) means the output floor would significantly reduce the efficiency of securitisation transactions.

More generally, even if the position of the ESAs that the prudential framework for banks is not responsible for the slow growth of the EU securitisation market is accepted (itself arguable), there was a missed opportunity for the ESAs to make wider recommendations targeted around addressing the unjustifiably punitive treatment of securitisations from a regulatory capital perspective.

Finally, the ESAs' recommendation to agree more substantial reforms on the

2 https://www.eba.europa.eu/sites/default/documents/files/document_library/Opinion%20on%20the%20regulatory%20treatment%20of%20NPE%20securitisations.pdf

securitisation risk weight formulas via the Basel process is an unsatisfactory and impractical solution because it would necessarily extend the current punitive treatment and uncertainty around reforms for several more years. It is clear that even if this process was followed and finalised quickly, the earliest such reforms could apply fully to EU banks is 2028.[3] If this route were to be followed it would need, at the very least, some wide-ranging transitional relief in order to be practical.

Liquidity framework

The ESAs also considered a recalibration of the Liquidity Coverage Ratio ("**LCR**") to permit certain securitisation positions to qualify as Level 2A High-Quality Liquid Assets ("**HQLA**"). Currently securitisations can only qualify under the securitisation-specific category of "Level 2B securitisations" that is slightly less favourably treated than other Level 2B assets. The ESAs noted that any such recalibration would have to be based on new observations under an LCR stress scenario. However, they acknowledged the challenge posed by the unavailability of sufficient data for measurement given that no LCR stress period had been observed in the banking system in the last few years.

The ESAs however noted that, in reality, only a negligible amount of securitisation positions, including STS securitisation positions, are taken into account in the LCR stress buffers and this has been the case from when the LCR was introduced in 2013 to date. They also held the view that "*there is a reasonable assumption that credit institutions have very small appetite to use securitisations as part of the LCR stress buffer or perceive a low marketability of security positions during LCR stress scenarios*"[4] given that the LCR levels of these institutions are very high, exceeding the minimum regulatory requirements. The ESAs considered upgrading securitisations from Level 2B to Level 2A HQLA which would mean an increase to the cap of the current 15% to 40% of the liquidity buffer, and concluded that there was no justification for this upgrade. On this basis, the ESAs considered that there was no change necessary to the liquidity framework.

From a practical perspective however, the position may not be quite as simple as banks preferring not to include securitisation positions in their LCR stress buffers for e.g. marketability reasons. Although securitisation positions are considered Level 2B assets, they are in fact treated worse than other Level 2B assets e.g. corporate debt securities. Article 13(2)[5] of the LCR Delegated Regulation sets out a long list of requirements which must be met by an ABS to qualify for inclusion in the LCR stress buffers, including (i) being Simple Transparent and Standardised ("**STS**"); (ii) being the most senior tranche; (iii) meeting stringent credit quality requirements; and (iv) being one of a limited list of asset classes (residential mortgages, auto loans/ leases, commercial loans, or consumer loans). Even where these requirements are all met, securitisations are subject to punitive maximum bucket sizes (15% of HQLA in total) and haircuts (25% for residential mortgage and auto securitisations and 35% for commercial and consumer loans). This reveals some circularity in the argument by the ESAs and throws up the question of whether securitisations are not liquid enough to be in the LCR because they are so poorly treated in the LCR, ensuring that they will never be liquid enough to be included in the LCR?

Notwithstanding the above, while it is acknowledged that credit institutions have historically not used a significant amount of ABS assets to make up their LCR buffers, it is disappointing that the ESAs have not taken advantage of the Call for Advice to recommend updates to the liquidity framework to at least reflect a consistent LCR calibration between securitisations and covered bonds, which in many ways should be regarded as a comparable asset class. At a minimum, this would have signalled a step towards improving the reputation of securitisation as a safe asset class (given empirical evidence since the financial crisis) and reduced the punitive regulatory treatment of ABS, particularly when compared to other asset classes. Commenting on the LCR calibration, the Association for Financial Markets in Europe ("**AFME**") argued that the LCR calibration which favours covered bonds over ABS should be revisited on the basis that while covered bonds were more liquid than ABS in the early 2010s, this position changed in 2016 and senior ABS have been consistently more liquid than covered bonds since then.[6]

The (Re)insurance Sector

The ESAs considered Solvency II and its effects on (re)insurers participation in the EU securitisation market. They noted that since it became effective in 2016, investments by (re)insurers in securitisations across Europe have been consistently low, amounting to approximately 12.5 billion or 0.33% of their total investment assets.[7] In addition, responses received on a survey conducted by EIOPA on (re)insurers indicated that for a vast majority of (re)insurers, the demand for securitisation products is low or non-existent while

3 https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_5386
4 https://www.eiopa.europa.eu/system/files/2022-12/jc_2022_66_-_jc_advice_on_the_review_of_the_securitisation_prudential_framework_-_banking.pdf
5 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0061
6 https://www.eiopa.europa.eu/system/files/2022-12/jc_2022_66_-_jc_advice_on_the_review_of_the_securitisation_prudential_framework_-_banking.pdf
7 https://www.eiopa.europa.eu/publications/investment-insurers-and-reinsurers-securitisations_en

securitisation investments are relevant for only a small number of (re)insurers.[8]

The ESAs also noted that the introduction of the STS criteria to the securitisation regulatory regime does not appear to have improved this situation, notwithstanding that the STS label attracts beneficial capital treatment. Although the ESAs acknowledged that the introduction of STS may have brought some changes in the volumes and categories of securitisation held by (re)insurers, they noted that no strong trends could be identified given the limited time series (as the STS regime was only introduced in 2019).[9]

The ESAs reported that findings from their survey indicated that (re)insurers' appetite for securitisations varied greatly among different undertakings for different reasons. One reason is the different asset-liability management of individual insurance undertakings which drives their investment behaviour. In addition, while some (re)insurers indicated that they would rather invest in other assets with better risk-return profiles, a vast majority of respondents seem to have never invested in securitisations and do not see the need to change their investment behaviour. In this regard, it is noted that less than 20% of the respondents had been active securitisation investors.

However, a small group of (re)insurers did indicate that they have refrained from investing in securitisation assets due to the high capital charges associated with such investments.

It is therefore unclear why the ESAs took the view that the overall risk sensitivity of the Solvency II risk charges for STS securitisation was appropriate for the time being and that there was no need to change the securitisation prudential framework for (re)insurers. Although the ESAs noted that the limited time series posed a challenge to their observations, industry stakeholders considered the ESAs response to be a disappointing response to correct the situation.

Indeed, there is a basic logical flaw in the ESAs' argument that the limited time series has posed a challenge in relation to their observations around the impact of Solvency II on securitisation investments. In this regard, one would have expected the ESAs to consider a time series *before and after* the introduction of Solvency II if they wanted to understand the effect of the introduction of Solvency II. Thus, even if more time passes and the ESAs consider that the limited time series problem has been overcome, any data regarding the impact of Solvency II on securitisation investments which considers only the period after the introduction of Solvency II is not likely to be very helpful in providing a clear picture of the effect of Solvency II on securitisation investments.

In addition to the ESAs own report that some (re)insurers identified the punitive capital treatment as being responsible for their low level of investment in securitisations, Insurance Europe (the European re(insurance) federation comprised of 37 national insurance associations) have criticised the capital costs of investing in securitisations as being too high in contrast to corporate bonds, thus making corporate bonds a significantly more attractive asset class for European (re)insurers. The below words from Insurance Europe are instructive:

> *"…the existing Solvency II capital requirements of securitised assets … do not reflect the risk and yield of this asset class. More specifically, the current capital charges for non-simple, transparent and standardised (STS) securitisation are unreasonably high and are not appropriately justified based on either past data or EIOPA's analysis. EIOPA's recent consultation paper does not provide any quantitative arguments that support the retention of the current factors for this category."*[10]

Since its publication, the JA has received significant criticism from key industry players. AFME suggested that there is evidence to support a recalibration of the prudential framework for banks and insurers and that the ESAs "*postulating that it is probably not worth making calibrations more risk sensitive and proportionate because they cannot quantify the benefit [was] no justification for inaction*".[11]

It should also be noted that although the European Commission has proposed[12] , and the Council of the EU has agreed[13] , certain reforms to Solvency II none of these reforms appear to be targeted specifically at reviving (re)insurers' investments in securitisations. Nonetheless, and despite the ESAs position in the JA, we understand the

8 https://www.eiopa.europa.eu/system/files/2022-12/jc_2022_67_-_jc_advice_on_the_review_of_the_securitisation_prudential_framework_-_insurance.pdf
9 https://www.eiopa.europa.eu/system/files/2022-12/jc_2022_67_-_jc_advice_on_the_review_of_the_securitisation_prudential_framework_-_insurance.pdf
10 Via the July 2022 Response to EIOPA Consultation Paper on the Advice on the Review of the Securitisation Prudential Framework for Solvency II: https://www.insuranceeurope.eu/publications/2677/response-to-eiopa-consultation-paper-on-the-advice-on-the-review-of-the-securitisation-prudential-framework-in-solvency-ii/#:~:text=While%20insurers%20are%20willing%20to,the%20key%20obstacles%20to%20investing.
11 https://www.afme.eu/news/press-releases/details/afme-disappointed-by-esas-inaction-on-securitisation--eu-legislators-should-provide-leadership-to-address-regulatory-imbalances
12 https://data.consilium.europa.eu/doc/document/ST-11763-2021-INIT/en/pdf
13 https://www.consilium.europa.eu/en/press/press-releases/2022/06/17/solvency-ii-council-agrees-its-position-on-updated-rules-for-insurance-companies/

Commission to be sympathetic to the need for some adjustments to the Solvency II framework for securitisation. That said, the JA position against such adjustments make the Commission's job of recalibration more difficult, since Commission staff would need to take on the technical analysis work that would normally be carried out by the ESAs in order to do so. In this respect, market participants may wish to consider engaging with their trade associations in order to put together detailed technical analysis and evidence to assist the Commission with this work.

For more on the changes being considered in relation to Solvency II, see the article entitled *“Solvency II (EU and UK): encouraging insurers back to the securitisation markets?*” later in this volume.

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SOLVENCY II (EU AND UK): ENCOURAGING INSURERS BACK TO THE SECURITISATION MARKETS?

Contributors: Precious Ivongbe, Emma Eaton, Kevin Ingram, Cheng Li Yow

Following the 2008 financial crisis, European (re)insurance companies cut back on their securitisation investments. This effect was aggravated by the introduction of Solvency II in 2016 which, in effect, penalised insurers' investments in securitisation. European insurers have yet to fully re-enter the securitisation markets. In this article, we consider the outlook for (re)insurers' participation in ABS markets in the coming years in light of proposed reforms to EU and UK regulatory regimes and the expected impact on (re)insurers' investment behaviour.

Key Issues

- Low participation of EU and UK (re)insurers in securitisations may be connected to punitive capital charges and UK matching adjustment rules under Solvency II.
- Revised capital requirements under STS do not appear to have revived EU and UK (re)insurers' interest in securitisations.
- UK proposal to amend matching adjustment rules to allow assets with highly predictable cashflows may increase UK (re)insurers' investments in securitisations.
- It is hoped that UK and EU will also review capital requirements with a view to making securitisations more attractive to (re)insurers.

Setting the Context

Securitisation was widely viewed by policymakers as a key driver of the 2008 global financial crisis and a significant contributor to the long chains of financial intermediation that worsened it. The uncertainty and loss of confidence in the ABS markets following the crisis led to a decline in securitisation issuances and investments across global markets. Although the European ABS market performed relatively well during the financial crisis as compared to its US counterpart (as measured by defaults and downgrades), the European ABS market nevertheless suffered a contraction from which it has yet to recover. According to data compiled by the Association for Financial Markets in Europe ("**AFME**"), annual placed issuance levels dropped from €450bn in the pre-crisis years (in 2006 – 2007) to €108bn as at the end of 2019[14], and fell further to €79bn by the end of 2022.[15]

As a response to the crisis, securitisation investors including banks, pension funds and insurance companies cut back on their securitisation investments. AFME estimates that the total European placed issuance fell to a record low of €24bn in 2009 as most of the securitisation transactions during this period were retained – typically to provide collateral for central bank liquidity schemes. In particular, the EU insurance industry witnessed a massive shrinkage in insurers' ABS portfolios. This contraction was driven by insurers' need to comply with more conservative post-crisis capital requirements, including for securitisation investments, which were introduced by the EU as a regulatory response to the crisis. The new capital requirements were introduced by Solvency II which was finalised in 2009 but did not become effective until 2016. The introduction of Solvency II resulted in European (re)insurance companies (which pre-crisis, were key ABS investors) reducing their ABS holdings. With Solvency II now effective (and onshored in the UK following the end of the Brexit implementation period), many European and UK insurers have exited the ABS markets. The European Insurance and Occupational Pensions Authority ("**EIOPA**") estimates that the volume of insurers' investments in European securitisations had stabilised at 0.34% of total investment assets since the introduction of Solvency II.

Solvency II

Solvency II (Directive (2009/138/EC) and associated legislation) introduced a new prudential regime for insurance and reinsurance undertakings in the EU. Compared to the old Solvency I framework, Solvency II takes a more risk-based approach to the calculation of capital that allows for an assessment of the overall solvency of (re)insurance undertakings.

The revised capital requirements and matching adjustment rules introduced under Solvency II have had an important impact on (re)insurers' investments in

14 https://www.afme.eu/key-issues/securitisation
15 https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Securitisation%20Data%20Snapshot%20Q1%202023.pdf

securitisations, which we explore in more detail below.

Capital requirements

Solvency II originally divided securitisation positions into three categories for the purpose of calculating capital charges. In descending order of capital intensity, they were type 1, type 2 and re-securitisation positions. Type 1 securitisation referred to the most senior tranche of a securitisation of certain common, granular asset classes and meeting relatively high credit quality criteria. Re-securitisations were securitisations whose underlying assets include securitisation positions. Type 2 securitisations were securitisations that were neither type 1 nor re-securitisations.

Under the 2016 Solvency II legislation, the risk factor used for the calculation of the capital charge for a senior RMBS with a credit quality step ("**CQS**")[16] of 1 and a 5-year modified duration was 15% whereas a CMBS with the same CQS and modified duration attracted a risk factor of 67% percent. In sharp contrast to this, a risk factor of 4.5%[17] would be applicable to a covered bond with the same CQS and modified duration and 5.5% for a similar corporate bond. Given the significant differences between the capital charges across various categories of securitisations as compared to comparable assets such as covered bonds and corporate bonds, Solvency II was considered to have the net effect of imposing penal capital charges on insurers with asset-backed securities in their portfolios, leading to calls for reform of the capital treatment of investments in securitisations.

These reforms came in the form of the Securitisation Regulation (Regulation (EU) 2017/2402) ("**EUSR**") which introduced simple, transparent and standardised ("**STS**") securitisations in the EU (which then included the UK). The STS categorisation modified the Solvency II capital calibrations relating to securitisations and replaced the "type 1, type 2 and re-securitisation" categorisations under Solvency II with (in descending order of capital intensity) "senior STS, non-Senior STS, non-STS and re-securitisations".

In effect, the capital charges for senior STS and comparable assets with similar risk profiles such as covered bonds and corporate bonds are broadly similar, thereby in theory, incentivising investments in senior STS securitisations, since these will normally have better yields at a given rating level. However, as a practical matter, according to EIOPA, insurers seem to prefer the non-STS category, which represents more than 70% of insurers' investments in securitisations in 2019 and 2020. This is true notwithstanding that the capital charges for non-senior STS securitisations are much lower than the charges for non-STS, suggesting that a possible explanation for (re)insurer securitisation investment behaviour lies outside the current calibration of Solvency II.[18]

In terms of the actual charges, there is still a significant divide between the capital charges for senior-STS and other categories of securitisations. A snapshot of the capital charges for different asset classes (all with an assumed modified duration of 5 years) is provided in the table below.

(5-Year Duration)	CQS 1	CQS 3	CQS 5
Covered bonds	4.5%	-	-
Bonds/loans	5.5%	12.5%	37.5%
STS senior	6.0%	14.0%	47.0%
STS non senior	17.0%	39.5%	100.0%
Non STS (other)	67.0%	98.5%	100.0%

The reduction in capital charges for senior-STS securitisations did not appear to significantly boost investments by (re)insurers in those tranches. In fact, EIOPA reports that since the introduction of the STS label in 2019, a small decrease in investments can be observed in the STS segment of the securitisation market.[19]

In our view, the clear preference shown by (re)insurers for non-STS securitisations over STS securitisations should have served as a basis for the ESAs to review the capital charges for this category to ensure they are risk-sensitive and permit, so far as is prudent, further investments in securitisations.

Matching adjustment

Solvency II also introduced matching adjustment rules as a countercyclicality measure in response to the duration mismatches which were considered to have increased the sensitivity of life insurers to declines in interest rates during the financial crisis. The matching adjustment offers beneficial capital treatment to insurers writing long-term products (e.g. annuities) who are able to demonstrate that their predictable liability cashflows are closely matched by their asset cashflows and they are therefore not materially exposed to the risk of having to realise those assets in unfavourable circumstances. The matching adjustment

16 The interpretation of the credit quality steps based on allocations by different external credit rating agencies is set out here: https://www.legislation.gov.uk/eur/2020/744/annex/data.xht?view=snippet&wrap=true
17 Article 180 of Commission Delegated Regulation (EU) 2015/35: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0035&rid=1
18 https://www.eiopa.europa.eu/system/files/2022-06/consultation_paper_on_cfa_on_securitisation_prudential_framework_in_solvency_ii.pdf
19 https://www.eiopa.europa.eu/system/files/2022-06/consultation_paper_on_cfa_on_securitisation_prudential_framework_in_solvency_ii.pdf

allows (re)insurers to recognise upfront, as loss-absorbing capital resources, a proportion of the spread that they hope to earn over the lifetime of their investments on the basis that the asset is intended to be held to maturity and the (re)insurer should therefore not be materially exposed to price movements, but to the risk of default only.

However, the ability of (re)insurers to comply with the matching adjustment rules is constrained by a need to satisfy strict 'fixity' requirements under the current regime. These rules require asset cash flows to be fixed in terms of timing, amount and currency, and not subject to change by the issuers or any third parties. This contrasts with the treatment of liability cashflows which merely have to be predictable and may pose a challenge for securitisation transactions given how typical securitisation transactions are structured around varying asset cash flows.

Interestingly, the UK Government reports that insurers and insurers' annuity funds were major investors in its 2018 securitisation of income contingent student loans.[20] It seems this asset class was attractive to insurers on the basis that the fixity requirements were met and the scheduled amortisation tranche was therefore capable of being held as part of insurers' matching adjustment portfolios.

It is clear from the matching adjustment rules above that cash flow matching for unexpected payments would not be possible as these would not meet the fixity requirement. This poses a challenge to insurers' ability to invest in certain asset classes including most securitisations. In the context of securitisations, deals with e.g. uncertain cash flows, callability and prepayment optionality, unscheduled amortisation and non-performance risk (rather than default risk), would ordinarily not qualify for inclusion in the insurers' matching adjustment-portfolios given that these cash flows would not be fixed in terms of timing and amount. In addition, the terms of certain underlying asset contracts could be considered to give the originator control over the cashflows, therefore failing the fixity requirement e.g. asset contracts which include an originator right to change the terms of the contract for matters such as re-pricing.

There is also an element of subjectivity even where a deal is structured to meet the matching adjustment requirements as set out in Solvency II. The risk remains that a product may not be captured by a firm's approved matching adjustment application, therefore requiring a new matching adjustment regulatory approval for the product.

Where the fixity requirement is not met due to uncertainty concerns, the matching adjustment rules nonetheless allow (re)insurers to include the asset in the matching adjustment portfolio where the terms of the debt provide for sufficient compensation to allow investor to replace lost cash flows by re-investing the uncertain amounts in assets of equivalent or better credit quality. This compensation could take the form of e.g. a make-whole payment for a bond whose cash flows do not meet the fixity requirement, which would require an additional layer of structuring in comparison with other assets such as non-callable corporate bonds. If there is no sufficient compensation, the matching adjustment rules provide that callable bonds may only be recognised up to the first date on which a call may be exercised, resulting in a more limited recognition of cash flows, possibly enough to make investments no longer economic.

It is worth remembering that insurance companies are not barred from holding assets which do not meet the matching adjustment criteria. However, from a practical perspective, we understand that many insurers consider the question of whether an ABS asset can be held in their matching adjustment portfolio as an important pre-condition to investing in ABS given the more favourable capital treatment thereby available. The consequences of including non-matching adjustment assets in a matching adjustment portfolio are also potentially onerous. If not fixed within 2 months, the insurer could lose its matching adjustment approval altogether.

Solvency II has been subject to criticisms from relevant stakeholders in relation to its contribution to the stalled revival of the European securitisation markets. In addition, market commentators have criticised the Solvency II capital charges for being too high and not reflective of default performance during the financial crisis. For example, a five-year securitisation will still have a capital default charge of over 15%. This is as compared to a total accumulative default rate during the crisis (2007 to 2013) of only 0.14%.[21]

This has led to several calls for reform by stakeholders in a bid to encourage (re)insurers to return to ABS markets and diversify their investments which in turn would contribute to the stability and growth of the real economy.

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20 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/914118/Second_Sale_of_Pre-2012_Student_Loans__2_.pdf
21 https://www.theia.org/sites/default/files/2019-05/20150513-ecsecuritisationframeworkresponse.pdf

Impact of EU and UK Securitisation Regulations

As part of its legislative review of the EUSR, the European Commission carried out a targeted public consultation.[22] Subject to some limitations to do with the amount of time the framework had been in place and the existence of exogenous factors affecting the market, respondents said "*they did not witness a widening of the investor or issuer base… on the contrary, respondents stated that the number of investors from some major sectors, such as insurance companies, had decreased*".

Similar industry engagements also took place in the UK in 2021 when HM Treasury published a call for evidence seeking responses on how the UK Securitisation Regulation ("**UKSR**") could be improved and received similar responses to those received by the EU Commission on the EUSR. A number of respondents noted in particular that the UKSR had "*not managed to sufficiently broaden the investor base of securitisations, especially among insurance companies and insurance funds*".

Both the EU and the UK (as part of the Edinburgh Reforms) are now considering reforms of the Solvency II regulatory framework for insurers with the objective of fuelling more investments by insurers, including in securitisations, but through different regulatory mechanisms as discussed below.

Direction of Travel of Solvency II in the UK and EU

The UK

The UK Government considers the opportunity for insurance regulatory reforms to be one of the early gains of Brexit. HM Treasury and the Prudential Regulatory Authority ("**PRA**") are expected to take advantage of the post-Brexit legislative freedoms to develop a homegrown insurance regulatory regime which addresses the idiosyncrasies of British insurers.

They have proposed reforms to Solvency II, which will be renamed "Solvency UK". Some of these reforms include (i) a substantial reduction in the risk margin by around 65% for long-term life insurance business and 30% for general insurance business; (ii) a more sensitive treatment of credit risk in the matching adjustment portfolio; (iii) allowing for the inclusion of assets with 'highly predictable' cash flows in matching portfolios (although the expectation is that the majority of the portfolio would still consist of fixed assets), subject to a number of safeguards to be implemented by the PRA; (iv) removing the disproportionately severe treatment of assets in matching adjustment portfolios with ratings below BBB; and (v) introducing greater flexibility in the treatment of matching adjustment applications and breaches.

The inclusion of assets with 'highly predictable' cash flows in matching adjustment portfolios is potentially a game changer for insurers as investors, particularly as it relates to insurers' investments in securitisations. This reform has the potential to substantially increase (re)insurers' appetite for investing in securitisations of assets with prepayment features and unscheduled amortisation profiles such as residential mortgages and credit cards where portfolio performance backing the investment is arguably 'highly predictable' but not fixed in terms of timing and amount.

EU Solvency II Reforms

Similar to the UK, the EU is considering changes to the Solvency II regime. These amendments are aimed at making the (re)insurance sector more resilient and prepared for future challenges, while stabilising insurers' capital requirements. In particular, proposals for reform include macroprudential tools which are likely to improve insurers' ability to withstand systemic shocks. However, no change is being considered to the existing matching adjustment rules and the fixity requirements, possibly because a vast majority of EU life insurers do not use this tool.

The EU is aware of the low level of securitisation investment by (re)insurers but Solvency II is not regarded as the problem. In October 2021, the EU Commission published a call for advice on the review of the securitisation prudential framework. In a joint response provided in 2022 that has been widely criticised, the three European Supervisory Authorities ("**ESAs**") concluded that the Solvency II framework did not seem to influence insurance activity in EU securitisations. They found insufficient evidence to conclude that the current capital requirements for spread risk on securitisation positions under Solvency II are not fit for purpose. They therefore recommended that the prudential framework for insurers and reinsurers should be maintained as it currently stands. For more information, see the article entitled "*ESAs Joint Advice: a false dawn for the European securitisation prudential framework?*" earlier in this volume.

As a result of their conclusions, the ESAs' response made no proposals for how to stimulate EU (re)insurers' investments in securitisations. This may be short-sighted if there is a policy aim to encourage (re)insurer investment in securitisations, particularly as they acknowledge that there was no evidence to show that the current regulatory regime has helped to

22 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52022DC0517

encourage insurers' investments in ABS assets.

The analysis by the ESAs appears to be flawed in a number of ways. One crucial flaw is that, in concluding that Solvency II is not the problem keeping (re)insurers out of the securitisation markets, the time series it examined failed to span the introduction of Solvency II. Instead, it started its analysis at the time Solvency II was already in place, meaning the effect of its introduction could not be inferred.

Conclusion

The UK appears to be pro-actively proposing positive steps to encourage insurers' investments in securitisations, although there is still a need to revisit the prudential requirements for UK insurance companies' investments in securitisations. On the other hand, it does not appear that the reforms being proposed by the EU would create similar momentum. We continue to hope that the EU will revisit its proposed Solvency II reforms and consider changes to the regime to broaden the investment options of EU (re)insurers, including by making securitisation investments capital charges more risk sensitive.

In addition, we are aware that there has been some interest in marketing transactions to insurers considering acquiring matching adjustment-compliant securitisation assets. While there have been a few recent transactions, particularly relating to equity release mortgages, there is yet to be a public securitisation transaction in any of the major traditional asset classes which has been structured to comply with the matching adjustment requirements. We hope that the proposed revisions to the matching adjustment rules in the UK will serve as a catalyst for the introduction of matching adjustment-compliant public securitisation issuances in the UK across a wide range of asset classes.

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UK EDINBURGH REFORMS: WHAT NEXT FOR UK FINANCIAL SERVICES?

Contributors: Stephanie Peacock, Paul Lenihan, Caroline Dawson

The Edinburgh Reforms will bring about the biggest change in UK financial services regulation since the Financial Services and Markets Act in 2001. So when will we start to see this change, what will it mean for regulated firms and market participants, and how does this fit with the broader programme for repeal of legacy EU legislation?

Key Issues

- The Edinburgh Reforms are not just about reforming retained EU law, but also about developing UK financial services regulation in key areas, including sustainable finance and digital assets.
- While significant progress is expected to be made on HM Treasury's priority areas in the course of 2023, completing the entire process of repeal and reform of retained EU law is expected to take several years and firms will need to be prepared for a rolling implementation process over that period.
- The reforms will also result in UK regulation starting to evolve in a different direction from EU regulation.

What are the Edinburgh Reforms?

The Edinburgh Reforms are a package of proposed changes to the UK's financial services regulatory regime announced by the Chancellor in Edinburgh in December 2022, setting out the most detailed proposals to date for the future of UK regulation. The Financial Services and Markets Bill ("**FSM Bill**") and the Retained EU Law (Revocation and Repeal) Bill ("**REUL Bill**") are designed to create the infrastructure the Government needs to implement the Edinburgh Reforms. Together they form the backbone of the Government's plans for repeal and replacement of legacy EU financial services legislation, as well as other proposals to reform the UK system of financial regulation.

The key measures covered in the Edinburgh Reforms are:

- Action to maintain the UK's position as a competitive marketplace promoting effective use of capital, including:
  - Publishing secondary legislation to implement certain aspects of the Wholesale Markets Review, such as reforming the ancillary activities test for commodity derivatives trading (this is the key test which determines whether predominantly non-financial commodity trading firms need to seek authorisation under the UK financial services regulatory framework);
  - Launching an independent investment research review (to examine the link between the levels of investment research and the attractiveness of the UK as a destination for companies to access capital) and a new industry led accelerated settlement taskforce (to explore the potential for faster settlement of financial trades in the UK, such as moving to a 'T+1' standard settlement period);
  - Committing to a UK consolidated tape by 2024, to bring together market data from multiple platforms into one continuous feed in order to improve market efficiency, lower costs and make UK markets more attractive and competitive;
  - Reforming the ring-fencing regime, which currently requires the largest UK banks to separate core retail banking services from their investment and international banking activities;
  - Overhauling the UK's prospectus regime (as to which see the article entitled "*The Proposed UK Prospectus Reforms: a change in approach?*" later in this volume) and delivering the outcomes of the Secondary Capital Raising Review;
  - Reforming the UK securitisation regime (as to which see our December 2022 briefing entitled "*UK Edinburgh Reforms: The New Securitisation Framework?*"[23]);
  - Repealing the Packaged Retail and Insurance-based Investment Products ("**PRIIPs**") Regulation, which introduced a complex retail disclosure regime for packaged products, and developing a new retail disclosure regime;
  - Repealing EU legislation on the European Long-Term Investment Fund ("**ELTIF**"), as well as making targeted changes to the tax regime for certain funds;

23 https://www.cliffordchance.com/briefings/2022/12/uk-edinburgh-reforms-the-new-securitisation-framework.html

- Launching a call for evidence on reforming the Short Selling Regulation;
- Reviewing the Senior Managers & Certification Regime, which requires pre-approval of individuals holding senior positions at UK regulated firms and sets personal accountability standards for employees at these firms.

- Steps to cement the UK's position as the premier financial centre for sustainable finance, including:
  - Publishing an updated Green Finance Strategy, setting out a framework for the UK to become the world's first Net Zero Aligned Financial Centre;
  - Consulting on bringing ESG ratings providers into the regulatory perimeter.
- Building on the FSM Bill to support innovation and leadership in emerging areas of finance and establish a safe regulatory environment for stablecoins and cryptoassets activities, including:
  - Consulting on a UK retail central bank digital currency;
  - Implementing a Financial Market Infrastructure Sandbox, to allow financial market infrastructures to test and adopt new technologies and practices (such as distributed ledger technology) by temporarily disapplying or modifying UK regulatory requirements.
- Delivering for consumers and businesses, including:
  - Consulting on Consumer Credit Act reform to facilitate innovation in the credit sector, increase accessibility of credit products and bolster existing consumer protections;
  - Removing certain performance fees from the pensions regulatory charge cap;
  - Working with the FCA on the boundary between regulated financial advice and financial guidance to ensure that the UK regulatory regime does not act as a barrier to firms delivering services to consumers.

How and When Will the Reforms be Implemented?

While some of these reforms can be achieved using existing regulatory powers (e.g. where the reforms can be achieved through amendments to FCA or PRA rules), the process of repealing and reforming retained EU law requires the introduction of new powers for HM Treasury and for the UK regulators. These new powers are introduced through the FSM Bill, which will repeal retained EU law on financial services and give HM Treasury powers to amend, restate and replace that law, while also ensuring that where retained EU law will be replaced by regulator rules, the regulators have appropriate powers to make those rules.

The FSM Bill will also introduce a new designated activities regime, which is expected to be used to regulate various activities that are currently regulated under retained EU law and could also be used to regulate new activities. The new regime will prohibit anyone from carrying on 'designated activities' (unless exempted) or carrying on those activities otherwise than in accordance with designated activity regulations or FCA rules adopted in accordance with those regulations. Designated activity regulations may impose requirements on both authorised and unauthorised persons, including persons outside the UK. HM Treasury has already indicated that it will use the designated activities regime in its reforms of the prospectus and securitisation regulations and it is expected to use it to regulate areas such as short selling and the margining of OTC derivatives.

The FSM Bill is expected to sit alongside the REUL Bill, which provides for the repeal of retained EU law that does not relate to financial services. The REUL Bill has been subject to greater political challenge and amendment, which has slowed its progress through the legislative process.

HM Treasury has identified 43 "core" files of retained EU law on financial services to be repealed and reformed under the FSM Bill. HM Treasury intends to prioritise the repeal and reform of these files by dividing them into tranches. The first two tranches of this programme are:

Tranche 1	Tranche 2
Work already underway in relation to: • the Wholesale Markets Review (which makes substantial amendments to the MiFID framework as implemented in the UK); • the repeal of the Prospectus Regulation and its replacement with an entirely new regime for admissions to trading and public offers; • the Securitisation Regulation review; and • the Solvency II review.	• Remaining implementation of the Wholesale Markets Review; • Further work on Solvency II; • PRIIPs Regulation; • Short Selling Regulation; • Taxonomy Regulation (which relates to ESG financial regulation); • Money Market Funds Regulation; • Payment Services Directive and E-money Directive; • Insurance Mediation and Distribution Directives; • Capital Requirements Regulation and Directive; • ELTIF Regulation; and • The consumer information rules in the Payment Accounts Regulations 2015.

While the FSM Bill gives HM Treasury and the FCA and PRA the powers needed to repeal and reform retained EU law, as well as to implement new regulatory regimes, it does not contain a "sunset" provision or date by which the reform process must be completed. In contrast, the REUL Bill originally envisaged the revocation of all retained EU law falling within the scope of that Bill by 31 December 2023 unless ministers actively decided to save it or to extend the revocation date. Following strong criticism of this approach, the Government tabled an amendment to replace the sunset clause with a list of specific retained EU laws that will be revoked at the end of 2023. Under the FSM Bill, there is no fixed date for the revocation of retained EU law on financial services. These will be reviewed by HM Treasury and actively either repealed or replaced.

HM Treasury expects to make "significant progress" on Tranches 1 and 2 by the end of 2023, but even once Tranches 1 and 2 have been progressed there will still be a large amount of work to undertake before the entire process of repealing retained EU law is complete, and HM Treasury has indicated that this will take a number of years.

As a result, firms will need to have in place a process for monitoring these developments, responding to consultations and calls for evidence and preparing for implementation over the coming years.

Growing Divergence from the EU?

As the reforms progress, we will also start to see the UK financial services regulatory

regime evolving along a different path from the EU regime. This will clearly be the case in areas where the UK is developing new regulation, rather than reforming legacy retained EU legislation (e.g. in areas such as cryptoassets regulation), but we are also already seeing differences in the way in which the EU is amending core financial services legislation such as MiFID and EMIR, against the amendments that the UK is proposing. While, at least initially, these differences are likely to be around points of detail rather than fundamental differences, for firms with business in both the EU and UK, this is going to require a more in-depth review of what those differences mean in practice, to ensure that they remain compliant with both EU and UK regulatory obligations.

Firms may intend to comply with both regimes by adopting a 'stricter of' compliance approach. However, this will only be feasible where the EU and UK rules do not conflict. We have already seen some instances post-Brexit where conflicting EU and UK rules had the potential to materially restrict cross-border trading; the EU and UK's respective mandatory trading obligations for shares and OTC derivatives would have had this effect had it not been for the FCA taking action under its temporary transitional powers. As both the EU and UK regulatory regimes develop, it will be imperative to ensure that new areas of conflict do not develop.

For more information, please see:

- **Chancellor of the Exchequer, Ministerial statement** https://questions-statements.parliament.uk/written-statements/detail/2022-12-09/HCWS425 (9 December 2022);
- **Financial Services: The Edinburgh Reforms** https://www.gov.uk/government/collections/financial-services-the-edinburgh-reforms (9 December 2022);
- **HM Treasury policy statement, Building a smarter financial services framework for the UK** https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1122734/Building_a_smarter_financial_services_framework_for_the_UK_.pdf (9 December 2022);
- **Clifford Chance briefing, UK Financial Services and Markets Bill: enacting the future regulatory framework** https://www.cliffordchance.com/briefings/2022/07/uk-financial-services-and-markets-bill--enacting-the-future-regu.html (July 2022);
- **Clifford Chance briefing, UK Edinburgh Reforms: The New Securitisation Framework?** https://www.cliffordchance.com/briefings/2022/12/uk-edinburgh-reforms-the-new-securitisation-framework.html (13 December 2022)
- **Clifford Chance briefing, UK Edinburgh Reforms: Impact on financial services** https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2022/12/uk-edinburgh-reforms-impact-on-financial-services.pdf (December 2022);
- **Topic Guide on UK Financial Services and Markets Bill on the Clifford Chance Financial Markets Toolkit:** https://financialmarketstoolkit.cliffordchance.com/en/topic-guides/uk-financial-services-and-markets-bill.html

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THE PROPOSED UK PROSPECTUS REFORMS: A CHANGE IN APPROACH?

Contributors: Jessica Walker, Julia Machin, Paul Deakins

As discussed in the article entitled "*UK Edinburgh Reforms: what next for UK financial services?*" earlier in this volume, the Government has stated that it will use its post Brexit legislative flexibility to redesign the UK financial services framework. In this article, we discuss how the UK Edinburgh Reforms look like they will affect the UK prospectus regime, including examining a new structure for the regime that separates "public offer" and "listing" prospectus exemptions and eliminates EU rules allowing for differentiated disclosure between "wholesale" and "retail" issues of debt securities.

Key Issues

- New designated activities regime and public offer prohibition.
- Separation of rules on public offers and listing.
- Elimination of "wholesale"/"retail" differentiated disclosure regime.
- Most of the detail still to come in the FCA rules.
- Practical outcomes likely to be similar to EU regime.

Introduction

Reform of the UK prospectus regime is part of the first tranche of legislation to be revised and the Government published an "illustrative" draft statutory instrument and related Policy Note on 9 December 2022 as part of the UK Edinburgh reform package. These give an indication of how the new regime will work. However, we currently only have half the story. This is because, in line with the general approach to the revision of financial services, much of the power to make rules will be delegated to the FCA under the new regime. The FCA is undertaking a thorough market feedback exercise in relation to the establishment of its rules under the new regime. It published four engagement papers on 18 May 2023 namely, Engagement Paper 1 "Admission to trading on a regulated market", Engagement Paper 2 "Further issuances of equity on regulated markets", Engagement Paper 3 "Protected forward-looking statements" and Engagement Paper 4 "Non equity securities". While these papers set out the positions the FCA is minded to take, including the areas in which it is considering adopting a different approach to that under the existing UK prospectus regime, these positions are just the starting points in the conversations with stakeholders. The engagement process is intended to result in draft rules for consultation being published in Q1 2024.

What we do know is that the structure of the legislation will be quite different from that under the current UK prospectus regime which was onshored as part of the Brexit process, so (currently) reflects the existing EU prospectus regime. It is entirely feasible that while the eventual statutory instrument and forthcoming FCA rules will 'rearrange the deckchairs', the outcomes will remain broadly similar to the existing regime. This is to some extent supported by statements in the Government's Edinburgh Reforms Policy Statement such as "*the government will not be pursuing change for its own sake*" and that "*much [retained EU law] will remain appropriate in substance*". The FCA has similarly stated that "*We recognise that there are strong arguments … that we should stick broadly with existing requirements as set out in the UK Prospectus Regulation*".[24] Regardless, these changes will require practitioners to think afresh and in a slightly different way when dealing with concepts they have got very familiar with over the last (almost) 20 years.

Designated Activities Regime

The illustrative draft statutory instrument (the Financial Services and Markets Act 2000 (Public Offers and Admissions to Trading) Regulations 2023 ("**SI**") fits within the new structure for financial services regulation set out in the Financial Services and Markets Bill ("**FSM Bill**") and the proposed "designated activities regime" ("**DAR**"). These are more fully described in the article entitled "*UK Edinburgh Reforms: what next for UK financial services?*" earlier in this volume. The SI specifies that offering securities to the public or admitting or requesting admission of securities to trading on a UK regulated market (i.e. the London Stock

24 Engagement Paper 1, Summary paragraph 4.

Exchange Main Market) or UK primary MTF (e.g. the PSM or ISM) will be designated activities. Related communications and advertisements will also be designated activities. The SI gives the FCA powers to make designated activity rules in relation to these activities. In developing its rules FCA is to "have regard" to the desirability of offers of transferable securities in the United Kingdom being made to a wide range of investors.

Separating the Public Offer and Listing Regime

The existing UK prospectus regime sets out the rules for when a prospectus is required, and the exemptions that apply, in relation to **both** public offers and admission of securities to trading on a regulated market (referred to as "listing"). In contrast, under the proposed new regime there will be a separation of offers and listing. In broad terms, the SI will create the new UK public offers regime but virtually all powers in relation to admission to trading on a regulated market, or a primary MTF, in the UK will be delegated to the FCA.

The Proposed New Public Offer Regime: relevant securities, transferable securities and excluded securities

The SI creates a prohibition on offers of "relevant securities" to the public and sets out a number of exceptions to the prohibition. Helpfully, the definition of a public offer remains the same as under the current UK prospectus regime.

Less helpfully, the definition of "relevant securities" is very broad. It includes "transferable securities" ("transferable securities" are subject to the current regime and the definition of "transferable securities" used in the SI remains the same as under existing English law) but also catches a range of financial contracts not currently within scope, such as loans and certain derivatives. The 9 December 2022 Policy Note published as part of the Edinburgh reforms indicated the main driver behind this broad definition was to bring minibonds in scope in order to deliver on a recommendation of the Gloster Review. However, there are serious market concerns on the breadth of the definition of "relevant securities" given the marked expansion in scope.

The SI excludes certain securities from the definition of relevant securities. (For the avoidance of doubt, these securities are carved out from (or "excluded" from) the scope of the definition itself, as opposed to being covered by one of the various exceptions to the public offer prohibition.) "Excluded securities" is a category that covers debt securities issued by certain types of issuer (e.g. sovereigns, local authorities, central banks), money market instruments with a maturity of less than 12 months, and debt securities issued by charities and housing associations.

Offers to the Public: exceptions old and new

There are a number of exceptions to the public offer prohibition and the SI states these may be combined. Some are familiar, some are not. The "general exceptions" mirror the current UK prospectus regime, these are:

- offers below a threshold amount - this threshold amount is yet to be determined;
- an offer of relevant securities addressed solely to qualified investors;
- an offer addressed to fewer than 150 persons in the UK (other than qualified investors);
- an offer of relevant securities whose denomination per unit amounts to at least £50,000 (or an equivalent amount); or
- an offer of relevant securities addressed to investors who acquire securities for a total consideration of at least £100,000 (or an equivalent amount) per investor, for each separate offer.

It is worth pointing out that minimum denomination exception of £50,000 would enable offers of €100,000 denominated securities (i.e. the denomination threshold for an exempt public offer under the EU Prospectus Regulation regime) to be offered in the UK. This though would not work 'vice versa' since an offering of securities with denominations of £50,000 into the EU would fall below the EU minimum "wholesale" denomination threshold of €100,000.

There are two exceptions to the public offer prohibition in the SI that would be new as compared to the existing regime. These are: an "offer of transferable securities admitted or to be admitted to trading" and an "offer by means of regulated platform".

An "offer of transferable securities admitted or to be admitted to trading" is described as being where the offer is conditional on the admission of the transferable securities to trading on a regulated market or primary MTF, or where the transferable securities are, at the time of the offer, admitted to trading on a regulated market or primary MTF. There is some uncertainty around the meaning of "conditional on the admission" and how

this might work in relation to offers that rely on this exception (although in the securitisation market other exceptions are likely to be available and will be typically used, such as the minimum denomination exception). This is because admission to trading in practice will follow after an offer has been made and accepted and the notes have been issued. Market participants will be familiar, for example, with risk factors warning that the notes may not be successfully listed (admitted to trading) – because the notes are only listed in practice after an offer has been made. Practitioners are therefore seeking clarity from HM Treasury on how this exception is intended to operate and what "conditional on" means – for example, would the offer have to lapse if the admission did not happen?

Little detail is available in respect of the "offer by means of regulated platform" exception. However, the 9 December 2022 Policy Note sets out that the Government intends to legislate to create a new regulated activity covering the operation of a public offer platform. The FCA will then determine the detailed requirements to which such platforms will be subject, including what disclosure is needed. The FCA engagement paper on public offer platforms is due to be published in June 2023.

Paragraphs 8-14 in Part 1 of Schedule 1 of the SI contain further exceptions, many of which replicate existing UK prospectus regime exemptions but are not especially relevant to structured debt instruments – such as, "offers to existing holders of equity securities", "offers by other company in connection with takeovers etc", an "offer of securities to directors or employees", "securities offered under banking or central counterparty special resolution regime", and an "offer of loan notes in connection with a takeover".

Admission to Trading and Prospectus Requirements

As mentioned above, the admission, or a request to admit, transferable securities to trading on a UK regulated market or primary MTF will be a designated activity and subject to the relevant FCA DAR rules. Key among these will be the requirement to prepare a prospectus and the rules relating to the preparation and publication of a prospectus.

Rules made by the FCA in respect of securities admitted to trading on a regulated market are referred to as "admission rules". These cover, among other things, when a prospectus must be published, how a prospectus is approved and the application process for prospectus approval, responsibility for a prospectus, its form and content, any permitted exemptions from disclosure, its validity period and details of publication.

The FCA Engagement Papers 1 and 4 make it clear that the FCA recognises the benefits of keeping its new rules aligned with the current UK regime and notably that "convergence rather than divergence" across jurisdictions is a desirable outcome for stakeholders (in this regard the FCA is particularly conscious of the ongoing EU Prospectus Regulation review). Key FCA starting points from the Engagement Papers are that:

- the prospectus content for admission to trading on a regulated market will remain broadly the same;
- there will be one prospectus disclosure standard based on the current "wholesale" standard;
- disclosure changes could be adopted in a few areas (to the extent stakeholders consider these to be improvements), such as:
  - prospectus summaries;
  - incorporation by reference of future information;
  - the use of forward looking statements; and
  - environmental, social and governance ("**ESG**");
- a simple standardised regime for seasoned UK corporate issuers with limited disclosure requirements could be introduced;
- the valid period of a prospectus may be extended;
- the prospectus exemptions for admission to trading will align with the public offer exemptions for excluded securities in the SI; and
- the prospectus threshold and/or content requirements will likely change in relation to secondary offers (more detail on these proposals can be found in Engagement Paper 2).

The FCA's rule-making powers in relation to securities admitted to trading on a primary MTF are more limited but include a requirement that the primary MTF operator includes in its rules that publication of a prospectus be a condition to admission to trading. The primary MTF operator will determine the form and content requirements of any prospectus prepared for admission on its MTF.

The Necessary Information Test, Forward-looking Statements and Withdrawal Rights

In the meantime, there are some provisions relating to the content of the prospectus specified in the SI that are worth highlighting.

The "necessary information" test

This is the overarching content test to determine what should be included in a prospectus and largely corresponds with the current Article 6 test under the UK Prospectus Regulation (see box), but with some differences, such as:

- the SI states that the "prospects" of the issuer are to be read as including, where appropriate, a reference to the "creditworthiness" of the issuer. Market participants have flagged that it is unclear how this should be interpreted and what other considerations should be taken into account in addition to credit;
- crucially for debt securities, what is considered "necessary information" will not vary depending on whether non-equity securities have a "wholesale" denomination – so while a minimum £50,000 denomination will be a public offer exception it will make no difference to the prospectus content requirements;
- the "necessary information" required in a prospectus may vary if the issuer already has relevant securities admitted to trading on a market and therefore is already subject to ongoing information disclosure requirements similar to the simplified disclosure regime for second issuances under Article 14 of the current UK Prospectus Regulation; and
- finally, while MTF operators will set out detailed prospectus rules, including content requirements, as mandated by the FCA – the primary MTF rules relating to prospectuses will also have to adhere to the "necessary information" test.

Article 6(1) of the UK Prospectus Regulation

… a prospectus shall contain the necessary information which is material to an investor for making an informed assessment of:

(a) the assets and liabilities, profits and losses, financial position, and prospects of the issuer and any guarantor;

(b) the rights attaching to the securities; and

(c) the reasons for the issuance and its impact on the issuer.

That information may vary depending on any of the following:

(a) the nature of the issuer;

(b) the type of securities;

(c) the circumstances of the issuer;

(d) where relevant, whether or not the non-equity securities have a denomination per unit of at least EUR 100,000 or are to be traded only on a market, or a specific segment thereof, to which only qualified investors can have access for the purposes of trading in the securities.

Forward-looking statements

The SI introduces a new liability carve out for protected "forward-looking statements", defined as a statement containing a projection or estimate, a statement of opinion as to future events or circumstances, or a statement of intention. For such a statement, subject to compliance with certain FCA rules, rather than the standard negligence threshold, liability will not attach unless a higher threshold is met – namely, knowledge or recklessness as to whether something was untrue or misleading, or knowledge that an omission was dishonest concealment of a material fact. This carve out is specified to only apply to a person "responsible" for a prospectus. It remains to be seen whether those involved in preparing a prospectus would want to include such forward-looking statements on this basis.

The FCA Engagement Paper 3 "Protected forward looking statements" seeks feedback from market participants on how protected forward looking statements ("**PFLS**") should be defined and how they should be presented. In particular, comments are sought in relation to what should be allowed as PFLS (and what should be excluded from scope), should sustainability-related disclosures be considered PFLS and how should PFLS be presented in a prospectus.

Withdrawal rights

The SI provides that a person who has agreed to buy relevant securities may withdraw that acceptance in circumstances specified in the "appropriate rules", which will be determined by the FCA or the MTF operator, as applicable. We assume the withdrawal rights will be connected to the publication of a supplemental prospectus as is the case under the current regime. It is worth noting that the withdrawal rights are specified as relating to all offers of relevant securities to the public. While this is the same as under current UK and EU prospectus legislation, the informal view in both markets (based on ESMA guidance) has been that withdrawal rights should not apply in relation to prospectuses prepared

for admission purposes only. Therefore, it has been noted by market participants that it would be useful if the FCA could similarly clarify in its rules that if any of the other public offer exceptions exist, e.g. minimum denominations or offers to qualified investors only, the withdrawal rights provisions need not apply.

There is no discussion of this particular point in the FCA Engagements Papers. Separately though, the FCA notes that withdrawal rights will need to be considered should its rules be changed to allow for incorporation of future information by reference in a prospectus. In this case it would result in a change to the existing practice of an issuer publishing a supplement in relation to regular financial information and investors would no longer have the benefit of the walkaway rights connected to such publication.

Other Aspects of the Regime

There are provisions in the SI in relation to the FCA's powers (such as to refuse approval of a prospectus, to suspend or prohibit public offers, to suspend or prohibit trading or admission to trading), penalties for breach of rules and censure and provisions around liability and compensation that are not discussed. These broadly speaking replicate existing FCA powers under the Financial Services and Markets Act 2000 ("**FSMA"**) and will be removed from FSMA once the SI is passed. In addition to these types of amendments to FSMA the SI will also make some necessary amendments to the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005.

What is still an unknown is whether a prospectus or offering document approved by a third county regulator could be acceptable for either admission to trading or for the purposes of a public offer in the UK. The 9 December 2022 Policy Note and the UK Prospectus Regime Review Outcome paper of March 2022 suggest that this type of "regulatory deference", may be considered by the Government, but certainly does not seem a priority at this stage.

Conclusion

Although the architecture of the regime may be changing, it is comforting for market participants to know that, as is the case under the existing UK prospectus regime, the new proposals mean a prospectus will still be required (a) to make a public offer of securities in the UK, unless an exception applies, and (b) to admit securities to trading on a regulated market (plus a primary MTF). The FCA Engagement Papers certainly suggest that the new rules will not be too disruptive to the wholesale debt markets. It is not in the FCA's interest to be so. However, as has been made clear, the Engagement Papers only represent the starting position of the FCA and there is room for change following discussions with stakeholders. It is also likely that there will be at least some changes, even if only at the margins of current practice, for example on incorporation by reference, the use of forward looking statements and ESG disclosure and requirements. An optimist would also hope that the stated aim of rulemaking being quicker, more agile and undertaken by the regulator who is 'closer to the action' than lawmakers will be achieved. But clearly, we are entering new territory as, even if the differences prove to be 'form over substance', the new approach will, inevitably, distinguish the UK regime significantly from its European counterpart.

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THE FCA CONSUMER DUTY: PRACTICAL IMPLICATIONS FOR MARKET PARTICIPANTS

Contributors: Laura Douglas, Soojean Choi, Adam Craig

The Consumer Duty aims to raise the bar for consumer protection across financial services by requiring UK-regulated firms to act to deliver good outcomes for retail customers. It will apply from 31 July 2023 for products and services that remain open for sale or renewal and its impact is already being seen on structured debt transactions involving regulated loan portfolios. In this article, we provide an overview of when the Consumer Duty applies, and the practical implications for structured debt transactions.

Key Issues

- The FCA Consumer Duty will introduce new requirements for UK-regulated firms to deliver good outcomes for retail customer, from 31 July 2023 for open products and 31 July 2024 for closed products.
- There is already a focus on Consumer Duty compliance in the context of due diligence and related contractual protections for purchasers.
- While rules do not technically apply to unregulated purchasers, the FCA indicates that sale to an unregulated purchaser should not result in worse customer outcomes.
- Purchasers and financiers in forward flow structures might be co-manufacturers of products, by virtue of rights that influence retail customer outcomes.
- The market approach to addressing Consumer Duty issues on structured debt transactions is still developing but it is hoped that a cohesive approach will emerge for day-to-day compliance points.

What is the FCA Consumer Duty?

The Consumer Duty aims to set higher and clearer standards of consumer protection across financial services and requires firms to take a consumer-focused and outcomes-based approach to compliance. There are three main elements to the new Consumer Duty, comprising:

- a new Consumer Principle, that "*a firm must act to deliver good outcomes for the retail consumers of its products*";
- cross-cutting rules supporting the Consumer Principle; and
- four outcomes, relating to the quality of firms' products and services, price and value, consumer understanding and consumer support.

The Consumer Duty rules and guidance are drafted in a product-agnostic way and overlay on top of existing sector-specific rules (such as MCOB for regulated mortgages and CONC for consumer lending). As such, they are supplemented by additional non-Handbook FCA guidance (FG22/5) to help firms interpret, implement and apply the Consumer Duty in practice.

Who Does the Consumer Duty Apply To?

The Consumer Duty applies to FCA-regulated firms that carry on "retail market business" – including regulated activities and ancillary activities carried on by a firm in a distribution chain which involves a retail customer. The definition of a "retail customer" for this purpose varies by sector to align with the scope of existing sector-specific rules (such as MCOB for regulated mortgages and CONC for activities relating to consumer lending).

Activities or products that fall under an exclusion from regulation are out of scope. For example, this means that for mortgages, the Consumer Duty does not apply to unregulated buy-to-let contracts or large business customers, following the application of MCOB. However, in practice, structured debt transactions may involve mixed portfolios of regulated and unregulated loans. Accordingly, some firms are considering a broader implementation of Consumer Duty requirements, for consistency across whole portfolios. In the consumer space, buy-now-pay-later loans are generally exempt products today, and will continue to be exempt with respect to the Consumer Duty. It should be noted, however, that buy-now-pay-later products are expected to be brought within the scope of regulation following the

recommendations of the Woolard Review in 2021. For more details on the ongoing HMT consultation on the proposed draft legislation for buy-now-pay-later products, please refer to our February 2023 briefing entitled "*Regulatory developments in the buy-now-pay-later space: HMT consultation on proposed draft legislation for BNPL products*"[25].

The Consumer Duty rules and guidance also make clear that the retail customer need not be a direct client of the firm for the Consumer Duty to apply. Therefore, even firms that do not have any direct retail clients need to assess whether they are carrying on retail market business by virtue of being in a "distribution chain" involving retail customers. FCA guidance indicates that a key element of this assessment is whether the firm can "determine or materially influence" retail customer outcomes. We discuss below how this may apply practically in the context of structured debt transactions.

Practical Implications for Structured Debt Transactions

Addressing regulatory risks arising from potential future Consumer Duty breaches

There is an increasing focus on Consumer Duty compliance in the context of due diligence and related contractual protections for purchasers. For example, the Consumer Duty represents a new set of regulatory obligations, breach of which could lead to the FCA requiring redress or remediation to be undertaken in a manner impacting the value of the portfolio.

Although the Consumer Duty does not seek to retrospectively impose Consumer Duty standards to origination processes, ongoing administration and treatment of customers is still within scope even for products that are considered "closed" (i.e. no longer open for sale or renewal) as at 31 July 2023. This will inevitably lead to more industry focus on the ability of originators and third-party servicers to ensure consistent and positive customer outcomes even when certain issues may stem from the time of origination rather than post-origination servicing, which is explored in further detail below.

In light of the above, it is likely that market participants will place greater emphasis on data and document completeness and availability as part of due diligence processes, as financiers and purchasers consider the implications of the Consumer Duty on the nature and scope of information they consider to be material for a transaction. Regulated acquirers of portfolios will need to place particular focus on such issues when agreeing servicing contracts.

Consumer Duty rules for portfolio sellers and purchasers

The FCA sets out its expectation that (regulated) firms that purchase books of regulated loans should continue to review customer outcomes to "*ensure consistency and provide appropriate levels of consumer protection*". The FCA is also introducing rules that require the seller to provide information to the purchaser of a book of regulated loans (and requiring a regulated purchaser to gather relevant information from the seller) to help the purchaser comply with the Consumer Duty. Therefore, it is likely that relevant agreements (including servicing agreements if the purchaser is not itself going to service the portfolio) will need to be considered carefully from this perspective. Such consideration will be particularly pertinent in the context of portfolio sales by sellers looking to divest themselves fully of a position and exit a specified market, as there is likely to be little (if any) ability to request further information from a seller following migration of the regulated loans.

There remains an ongoing discussion around how regulated and unregulated sellers and buyers of portfolios ensure ongoing compliance with the Consumer Duty post-sale or, as applicable, acquisition of a portfolio of loans. On one end of the spectrum is the well-trodden path of requiring a chain of deeds of covenant or similar extending through to subsequent assignees and transferees. On the other end is relying on pre-existing covenants relating to general compliance with applicable law and/or reference to a prudent lender standard. As the market develops its approach to the application of Consumer Duty to transactions, this is likely to be a key area of attention for firms as they consider how best to address the FCA's focus on ensuring no worse customer outcomes arise due to a sale of a portfolio. It is likely that at least initially, participants lean towards the more conservative approach of requiring at minimum a specific reference to Consumer Duty to address the point more explicitly, and to show the FCA that minds have been turned to consideration of the Consumer Duty's implications.

Portfolio acquisitions by an unregulated purchaser

The FCA's Consumer Duty rules and guidance apply only to FCA-regulated firms, meaning that unregulated firms are not subject to the Consumer Duty. This is a consequence of the limits of the FCA's rule-making powers (as much as any policy decision by the FCA on the scope of the Consumer Duty). While HM Treasury will have powers granted under the Financial Services and Markets Bill to

25 https://www.cliffordchance.com/briefings/2023/02/regulatory-developments-in-the-buy-now-pay-later-space--hmt-cons.html

create new "designated activities" with respect to which the FCA could make rules that even bind firms not authorised by them, there have been no plans announced to make use of this regime for the Consumer Duty.

However, the FCA strongly encourages unregulated purchasers of loan portfolios to act in a manner consistent with the Consumer Duty, despite the fact that the FCA does not strictly have powers to require this. In practice, many such unregulated firms sit within groups containing regulated firms or are otherwise subject to some level of control by regulated entities. The presence of a regulated firm in the group could act as an incentive to effectively require unregulated firms to comply even though they are not technically in scope particularly if decisions are taken at a business level across different legal vehicles.

Forward flow structures and co-manufacturing considerations

Firms entering into forward flow arrangements should also consider whether these may involve the purchaser acting as a co-manufacturer of the relevant loans.

FCA rules define "manufacturers" as firms that "*create, develop, design, issue, operate or underwrite a product or service*". In its policy statement, the FCA explains that multiple firms may be involved in the manufacture of a single product, in which case the firms are "co-manufacturers", and gives the example that "*intermediaries may be co-manufacturers, for example if they set the parameters of a product and commission other firms to build it*". In the context of forward flow arrangements, purchasers will need to consider if they may be co-manufacturers (alongside the originator) particularly if they set parameters of mortgage loans or other products they agree to purchase.

Firms that purchase loan books may also be classed as "manufacturers", according to FCA feedback in Policy Statement PS22/9, which explains that "*while firms that purchase books of closed products or services from the original manufacturer do not originate or design a product or service, they would be managing, operating or carrying out activities in relation to the book, which means they would be classed as manufacturers*". However, this statement does seem to assume that the purchaser takes an active role in managing or servicing the portfolio, so particular consideration will be needed as to how this analysis applies where the purchaser does not also take on any servicing role, or manage, operate or carry out other activities relating to the purchased loans.

In practice, whether a firm should be considered a "manufacturer" in the context of a forward flow transaction will depend heavily on the types of rights afforded to a purchaser or financier and how they link to consumer outcomes, and whether the level of rights granted is sufficient for the purchaser or financier to determine or materially influence those consumer outcomes. In addition, the circumstances of a particular originator (including, for example, availability of other sources of financing) and the context in which purchaser/financier rights are exercised may also be relevant. Therefore, firms should consider the specific facts of each forward flow arrangement and determine whether they are appropriately classified as a "manufacturer".

Application to closed products

The Consumer Duty will apply not only to new and existing products and services that remain open to sale or renewal (referred to as "open" products), but also to the way firms continue to service existing products that are no longer open for sale or renewal as at 31 July 2023 (referred to as "closed" products). Firms will have an extra year to comply with the Consumer Duty with respect to closed products, meaning the Consumer Duty will apply to closed products from 31 July 2024. The FCA indicates that it does not consider this application of the Consumer Duty to closed products and services to be retrospective. Rather, its focus is on how firms continue to operate and service those existing products.

However, this gives rise to various complexities, some of which the FCA addresses in its policy statement and final guidance on the Consumer Duty. For example, in relation to the "price and value" outcome, the FCA indicates firms should "*be confident there is a reasonable relationship, on an ongoing basis, between the price the customer is paying and the benefits of the product or service*". However, firms can look at the whole picture, including whether the product was transparently sold and whether customers are able to exercise choices to switch or exit from the product and are supported in their ability to do so.

Where firms identify that a product is no longer fair value, the Consumer Duty rules confirm that firms do not need to amend vested contractual rights to address this. In this context, the FCA's finalised guidance indicates that vested contractual rights include fees and charges already due or which fall due on occurrence of a contractually specified event (for example, exit charges). Therefore, it appears that the FCA does not expect firms to give up their rights to early exit charges - although it notes they "*would be free to do so*".

However, firms are expected to "*take appropriate action to avoid causing foreseeable harm and provide fair value. For example, they could consider changing non vested fees or charges, where doing so would not impact on any vested rights, providing additional support or information to customers, or offering forbearance, such as a pause in payments*." Where the issue arises in respect of a vested right to fees or charges, the FCA suggests firms could instead "*provid[e] greater flexibility on how customers can engage with a product or assist... a customer to switch to a new product or service that does not have the same issues*". However, these alternative mitigation actions may not be practical in all circumstances.

Timing and Next Steps

As noted above, the FCA Consumer Duty will apply from 31 July 2023 to open products and from 31 July 2024 to closed products, though the FCA sets out interim deadlines it expects firms to work towards in Policy Statement PS22/9 on the Consumer Duty. In particular, the FCA expects:

- all impacted firms should have agreed their implementation plans which should have been approved at board or senior management level by the end of October 2022; and
- product manufacturers should have shared information with distributors by the end of April 2023 to enable distributors to meet their obligations under the Consumer Duty.

Once firms have identified in-scope business and activities, their implementation will then need to focus on ensuring that both the high-level duty and more detailed rules and guidance are implemented through systems, controls, policies, procedures and other documentation across all in-scope business and products. The FCA's indications have been that it generally expects to see active engagement with the Consumer Duty, and expects regulated firms to evidence intended changes to policies and processes as a result of implementing the Consumer Duty.

FCA Engagement

From its policy statement, the FCA indicates that it intends to take a fairly hands-on approach to supervising firms' implementation of the Consumer Duty. For example, the FCA states it may ask firms to share copies of their implementation plans, board papers and minutes with their supervisors and prepare to be challenged on their contents. Therefore, robust planning, record-keeping and internal governance will be important in meeting FCA expectations on Consumer Duty implementation.

The FCA also reminds firms of their notification obligations under Principle 11 and SUP 15 in the FCA Handbook. In particular, the FCA indicates it expects firms to notify and engage with the FCA if firms:

- are considering withdrawing or restricting access to products or services in a way that will have a significant impact on vulnerable customers or overall market supply,
- identify significant breaches of existing rules (including Principle 6 on treating customers fairly) as part of their implementation of the Consumer Duty, or
- believe they will not be able to complete their implementation of the Consumer Duty on time (and notes that firms should take a risk-based approach to implementation by prioritising work that is likely to have the biggest impact on consumer outcomes in this case).

Looking Forward

Generally, we expect the FCA to take an early intervention approach to supervision and enforcement of the Consumer Duty, by signposting areas of focus and potential concern. Consistent with this approach, the FCA provided feedback on firms' implementation plans on 25 January 2023, identifying examples of poor and good practice. Key messages from the FCA emphasise the need for effective prioritisation of implementation in areas where risk of poor customer outcomes is highest, a mindset-shift to focus on substantive consumer outcomes and warning against assuming existing policies and procedures will suffice, and for firms in distribution chains to ensure they have engaged with and shared information as needed with other firms in the chain in time.

The FCA has also published various sector-specific "Dear CEO" letters from February and March 2023 on key issues for firms in sectors including (a) mortgage lenders and administrators, (b) consumer credit lenders, and (c) debt purchasers and administrators, to consider in implementing the Consumer Duty. Among other things the FCA highlights its expectations for firms to support customers impacted by the rising cost of

living, and reminds firms of their obligations in the context of portfolio sales to unregulated entities. The FCA also indicates that it expects high-cost lending back books may contain high levels of existing redress due to unaffordable lending historically and that, where this is the case, firms should act to mitigate consumer harm arising from this emerging risk.

With the deadline for the Consumer Duty fast approaching, and as market participants turn their minds to the practical implications of the Consumer Duty on both their businesses and transactions, it is hoped that the market will land on a cohesive approach to the more day-to-day compliance points – although it is inevitable that a degree of divergence will continue for some time on the more fact-dependent aspects of the regulations.

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ESG SECURITISATION: WEATHERING THE STORM?

Contributors: Maddie Burrell, Mikhail Kleptsov, Adam Craig, Jonathan Lewis, Julia Tsybina

Environmental, social and governance ("**ESG**") factors have become a permanent fixture of the financial markets in recent years. Investors globally are recognising the benefit in incorporating sustainability and responsible decision-making into their investment frameworks. ESG securitisation was slower off the mark than other forms of ESG finance, but has gained momentum in recent years. This article will explore the key challenges and opportunities for originators, arrangers and investors seeking to incorporate ESG factors in securitisation. It will look at recent regulatory and market trends and consider the future direction of travel for ESG securitisation.

Key Issues

- ESG securitisation issuance volumes slowed in 2022 after a boom in 2021, in line with broader market trends.
- The ESG securitisation market in Europe is relatively modest compared to that in the US and China. There are clear opportunities for future growth as the availability of ESG eligible collateral increases.
- The regulatory framework in this area continues to develop in response to market feedback. The new European Green Bond Standard contains provisions which facilitate its application to securitisations, which we expect to play an important part in addressing existing labelling concerns.

General Background

ESG investment saw a boom in 2021, with figures published by AFME showing European ESG bond and loan issuance volumes rising from €396.4bn in 2020 to €749.8bn in 2021.[26] These volumes fell to €680bn in 2022[27] , reflecting broader macro-economic conditions in the public markets. Similarly, European ESG securitisation issuances jumped from €2.1bn issued in 2020 to €8bn in 2021 before a quieter year in 2022 when volumes fell to €1.2bn (making up less than 0.2% of total ESG issuances in 2022). As these figures demonstrate, ESG securitisation volumes have remained relatively modest as a proportion of the overall green and sustainability-linked financing market, with only a small handful of ESG-labelled deals. In 2022, the public markets have been a challenging environment – has this caused issuers to focus primarily on execution risk at the expense of ESG factors?

One of the reasons for the fairly modest issuance volumes in 2022 was undoubtedly the challenging economic and market environment which persisted for the most part of the year. Against that backdrop, it would hardly come as a surprise that the lack of clear ESG standards for securitisation, and a shortage of eligible collateral, continued to limit the growth of ESG securitisation.

Nonetheless, continued focus on ESG factors in the broader finance markets remains the main driving force for growth of ESG securitisations. It gives hope that overall volumes will recover and grow as market conditions stabilise and improve, and the regulatory framework for ESG securitisations is refined and clarified through a number of existing and future initiatives. In particular, the provisions of the new European Green Bond Standard ("**EuGBS**") which facilitate its application to securitisations will undoubtedly play an important part in addressing at least some of the existing labelling concerns and supporting future growth.

What Has Happened So Far?

Labelling of ESG securitisation has remained one of the main areas of focus, but this tends to get bogged down in concerns over which metric(s) to use to determine if a securitisation "counts" as ESG. This remains a matter of debate and feeds into an overall environment where many market participants opt out of seeking an ESG label over greenwashing concerns.

As the European Banking Authority notes in its report on "Developing a Framework for Sustainable Securitisation"[28] (the "**EBA Report**"), there are at least three types of

26 AFME, "Q4 2021 and 2021 Full Year ESG Finance Report": https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Sustainable%20Finance%20Report%20-%20Q421%20and%202021FY.pdf

27 AFME, "Q4 2022 and Full Year 2022 ESG Finance Report": https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20ESG%20Finance%20Report%20Q4%202022%20and%202022FY-1.pdf

28 https://www.eba.europa.eu/eba-recommends-adjustments-proposed-eu-green-bond-standard-regards-securitisation-transactions

frameworks that can be used to classify a securitisation as meeting ESG standards:

(i) securitisations backed by ESG assets;

(ii) securitisations where the proceeds of sale of the assets are used for some ESG purpose by the originator; and

(iii) securitisations where the key counterparties commit to achieving certain sustainability-related KPIs.[29]

The choice between these three main options is not always easy and the categories are not mutually exclusive. For example, even where a securitisation relies primarily on use of proceeds to claim ESG status, it may also be structured to ensure that the underlying assets comply with a minimal ESG standard (something akin to the "do no significant harm" principle from the EU Taxonomy Regulation[30]) so as not to put off investors who may not wish to fund an "ESG" investment backed by e.g. high-emissions diesel cars. Additionally, there are several existing securitisations which would arguably meet ESG standards despite not having been identified as ESG transactions. A good example in particular is near-prime consumer lending, which may well fall under the "social" limb of ESG. This begs the question as to why these transactions do not seek ESG labelling. One of the contributing factors is likely the lack of clarity over the relevant metric(s).

All of this, combined with the supply-side constraints, translates into relatively low issuance volumes for ESG securitisations in Europe to date, at least in the main consumer asset classes.[31]

One notable transaction issued in 2022 is the Koromo issuance for Toyota in Italy which was backed by alternative fuel vehicle loans, which were over 98 per cent. straight hybrid vehicles (i.e. vehicles that recharge their electric batteries using their petrol-powered engines). Toyota chose to not seek second party verification of the ESG status of this transaction, as it is reported to be waiting to bring a deal to market with "greener" collateral (i.e. a higher percentage of the asset pool relating to plug-in hybrid or electric vehicles, which have less environmental impact) before it seeks such certification. This is an example of a general concern about what constitutes a "truly green" asset pool, which has led deals in large part to rely on green use of proceeds by the originator to obtain external ESG verification, rather than on green assets being funded by the deal.

On the social side of ESG, questions around what it means to be a "social" securitisation continue to persist, with new issuance of "social" transactions remaining rather scarce despite the potential of the existing near-prime consumer credit market.

Opportunities and Challenges

Comparisons with the ESG securitisation market in the US and China suggest that ESG securitisation in Europe has great potential for growth, with ESG securitisation constituting only 1.4% of total ESG issuances in Europe between 2019-2022, in comparison to 8.1% in China and 32.3% in the US.[32] Given the relatively modest ESG securitisation market in Europe, together with the ever-increasing demand for ESG investment products, there are clear opportunities for future growth of ESG securitisations. However, there remain two key challenges in this space.

First, supplies of eligible collateral are limited, particularly in the RMBS space which remains the main consumer asset class by volume. For certain consumer asset classes there are clear options for how securitised assets could meet ESG criteria (e.g. excellent EPC ratings for homes financed in an RMBS, low emissions/electric cars for auto ABS, near-prime credit cards for UK credit card securitisation). However, the inventories of mortgage loans financing appropriately-rated homes are insufficient to support large volumes of issuance. To meet reporting criteria, originators/sellers require verifiable, easily comparable, and high-quality information on asset portfolios. This can be challenging to obtain for legacy portfolios (e.g. portfolios of older homes for which EPC certificates are less readily available). This challenge is a key reason CLOs have led the way for European ESG securitisation.

However, the quantity of ESG assets and the quality of available information in respect of consumer assets continues to grow at a rapid pace. AFME and S&P Global Ratings predict that potential securitisable green lending to households across 8 major European markets could

29 We note that certain synthetic securitisations have involved undertakings to use the regulatory capital saved to originate eligible ESG financings.

30 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32020R0852

31 We note nevertheless that while the volumes are relatively low, there have been a wide variety of transactions which could be viewed as "ESG themed" securitisations including ABCP, RMBS, CMBS and synthetics with ESG features.

32 AFME, "European Green Securitisation Regulatory State of Play": https://www.afme.eu/portals/0/dispatchfeaturedimages/afme_esgsecuritisation_2022_07_final-2.pdf?utm_campaign=esgsecuritisation&utm_source=afme&utm_medium=email&dm_i=3TYX,1Il37,2D3JR8,5LFDA,1

exceed €300bn annually by 2030.[33] This includes predicted annual gross green mortgage lending of €125bn. In the electric vehicle space, they forecast securitisable financing for new battery electric vehicles of €80bn annually across five major European economies, with a further €30bn in annual financing for used electric vehicles.[34]

Another solution to the shortage of ESG assets currently available may be to source collateral from multiple jurisdictions. Although sourcing from a single jurisdiction offers simplicity of analysis for investors, taking a cross-jurisdictional asset pool may provide greater scale and diversification of risk. It might also be possible to source collateral from developing nations or regions where there is either a "green" context in terms of conservation of the environment or promoting projects with a significant social impact (e.g. on housing, health or promoting sustainable energy transition or development).

The second challenge is that the market remains focussed on finding the right balance between – on the one hand – standardisation, transparency and verification across different types of ESG securitisations and – on the other hand – the risks of creating an overly regulated landscape with overlapping and conflicting frameworks and potentially prohibitive compliance costs. Achieving the right balance between these conflicting demands has remained the major challenge faced by the ESG securitisation market. It seems that creation of a specific regulatory framework for ESG securitisations remains off the table at present, with the main solution in focus being the "use of proceeds" paradigm adopted for securitisations in the context of the EuGBS. This may be the best way for the market to fund the ESG transition (i.e. the creation of a large stock of ESG assets) while the desired ESG "end state" remains a more long-term goal.

The question of how best to verify the ESG status of securitisations also remains open. ESMA published a letter in June 2022[35] summarising concerns raised in response to a call for evidence about ESG ratings providers. Concerns surrounded:

(i) lack of coverage of specific industries;

(ii) insufficient granularity of data;

(iii) complexity; and

(iv) lack of transparency around methodology.

Investors in any case conduct their own detailed due diligence on securitised portfolios using available data, but availability of consistent and accurate ratings would assist these important investment decisions and provide a means of external validation for investor's processes.

Regulatory Framework and Market Initiatives

As described in our April 2022 briefing "*ESG Securitisation: accelerating after a slow start*"[36], there are a number of regulations and regulatory initiatives which apply on the buy- and sell-side.

We consider the key developments for each below.

"Buy side" regulation

In the EU, the main framework remains the Sustainable Finance Disclosure Regulation ("**SFDR**")[37] which established the framework for both entity- and product-level disclosures applicable to asset managers. Its application to securitisations has largely been indirect (with only CLOs managed by EU managers being caught directly) and has resulted in "in-scope" investors seeking additional disclosures on deals they are buying to enable them, in turn, provide the required disclosures to their own stakeholders. The SFDR remains a significant piece of legislation which establishes an ESG reporting standard across financial markets.

The Corporate Sustainability Reporting Directive ("**CSRD**")[38] significantly expands the scope of entities which are subject to sustainability reporting obligations. All large public-interest companies with more than 500 employees, including banks, incorporated in the EU will be required to report according to European Sustainability Reporting Standards. The CSRD is intended to ensure that investors have greater access to information required to assess investment risk arising from climate change and other

33 AFME, "European Green Securitisation Regulatory State of Play", as above.
34 AFME, "European Green Securitisation Regulatory State of Play", as above
35 https://www.esma.europa.eu/sites/default/files/library/esma80-416-347_letter_on_esg_ratings_call_for_evidence_june_2022.pdf
36 https://www.cliffordchance.com/briefings/2022/04/esg-securitisation--accelerating-after-a-slow-start.html
37 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 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088
38 Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.

sustainability issues. It will play an important role in setting the ESG agenda for the financial investor community as a whole, including in the ESG securitisation market.

In the UK, discussions around the UK equivalent of the SFDR, the Sustainable Disclosure Regulation ("**SDR**") are still ongoing, with the final rules expected at some point in mid-2023 and the key elements of the SDR regime proposed to apply from mid-2024. Industry's main outstanding questions are around the mapping of the SFDR labels onto the SDR labels and the scope of the future regulatory divergence between the EU and the UK regimes. The UK Green Taxonomy consultation is expected in autumn 2023. Finally, in March 2023, the UK Government expanded on its Green Finance Strategy which forms part of the broader framework for mandating ESG disclosures for financial investors[39] .

"Sell side" regulation

On the sell-side, political agreement was reached in relation to a European Green Bond Standard in November 2022.[40] The original Commission proposal for this regulation was largely inspired by the ICMA Green Bond Principles. The EuGBS Regulation departs from those principles in a number of substantive ways but will give the framework a formal regulatory status as a voluntary standard.

At the time of publication, the EuGBS Regulation is going through the final steps of the legislative process. It is likely to begin to apply some time in H2 2024. The EuGBS follows a "use of proceeds" approach for the designation of European green bonds. It requires that proceeds of such bonds are allocated in a way that fulfils requirements set out in the EU taxonomy regulation and satisfies specific conditions set out in the EuGBS, although there is some flexibility for up to 15% of the proceeds in certain circumstances.

Issuers located in "non-cooperative" jurisdiction for tax purposes or "high-risk"countries for anti-money laundering purposes are effectively barred from seeking the "European green bond" label.

The EuGBS includes provisions addressing transparency and external review requirements that apply throughout the cycle of each European green bond issue. In particular, there is a detailed factsheet that has to be produced before issuance, a periodic allocation report to account for the use of proceeds by the issuer and a report on the environmental impact of the use of the bond's proceeds. Each of these reports is required to be externally reviewed and published such that it remains in the public domain for at least 12 months after the maturity of the bonds concerned.

In addition to mandatory reporting, the EuGBS establishes a framework for voluntary disclosure in relation to environmentally sustainable and sustainability-linked bonds. No form of voluntary reporting has been prescribed – rather, the Commission has been given a mandate to develop reporting templates suitable for both pre- and post-issuance reporting.

In order to adapt these requirements to securitisation, the EuGBS Regulation includes conditions specific to securitisation. The main such condition is that the entity responsible for the satisfaction of the relevant requirements is the originator and not the SSPE (i.e. issuer) for securitisation transactions. There are also provisions addressing the situation where there are multiple originators. The EuGBS makes bonds issued for the purposes of synthetic securitisation explicitly ineligible for the designation as "European green bonds".

Another securitisation-specific requirement is that, in order for securitisation bonds to be eligible for the designation, the securitised exposures cannot include exposures financing the exploration, mining, extraction, production, processing, storage, refining or distribution, including transportation, and trade of fossil fuels. This is to avoid the reputation of the EuGBS being undermined if bonds with the label were used to finance existing fossil fuel assets. Originators are required to include a description of how the requirement as to the composition of the securitised exposures has been met in the pre-issuance fact sheet. In addition, competent authorities have been granted powers to request that originators demonstrate that this requirement has been fulfilled.

Finally, the EuGBS introduces securitisation-specific disclosure requirements. The securitisation prospectus must make it clear that the transaction is a securitisation and that the responsibility for fulfilling the EuGBS use of proceeds commitments falls on the originator. In addition, the prospectus must include disclosure about the assets' taxonomy alignment, taxonomy eligibility and compliance with "do no significant harm" principles, in each case on a "best efforts" basis and to the best of the relevant originator's ability, based on available data. These qualifiers are

39 HM Government, "Mobilising Green Investment – 2023 Green Finance Strategy": https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1147377/mobilising-green-investment-2023-green-finance-strategy.pdf

40 https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/european-green-bond-standard_en

especially important because the historic nature of a number of securitised assets creates significant challenges to the collection of the relevant data. This asset level disclosure is required before issuance and also on a periodic basis after issuance.

Supranationals and development banks as catalysts

Many of the supra-national development banks and international financial institutions ("**IFIs**") have clearly embraced the ESG agenda. They can be valuable catalysts to the development of the ESG securitisation market (both cash and synthetic). They mainly assist by giving technical support, by acting as anchor investors for certain tranches or by providing full or partial transaction guarantees to promote interest and investment in this developing market, thereby supporting the move to a sustainable economy, growth and human welfare.

Conclusion

ESG securitisation offers valuable benefits – not only by unlocking financing for those segments of the real economy which are aligned with ESG factors but cannot tap into the traditional bond or loan markets – but also ultimately by directing wholesale capital markets investments to achieve sustainability goals and long-term benefits for humanity. Opening up a European ESG securitisation market would also source new investment products for investors who have a keen appetite to invest in ESG assets. Although the challenging market conditions which persisted throughout 2022 have not made the task of putting ESG securitisations together easier, there remains hope that more recent initiatives, such as the EuGBS, will help resolve at least some of the concerns around labelling, standardisation and transparency and encourage market recovery and future growth of the ESG securitisation market.

The combination of regulatory innovation and the use of IFIs and development banks to act as a catalyst for wholesale investment may well permit the European ESG securitisation market to close the gap on its US and Asian counterparts in the years ahead.

ZUMELTZA 3 km

NPL PORTFOLIO DISPOSALS: A WAY FORWARD?

Contributors: Antonia Walter, Chris Bates, Lounia Czupper, Eduardo Garcia, Dr. Oliver Kronat, Alberto Maero, Jesus Quesada, Tanja Svetina

A number of broader macroeconomic drivers look likely to increase the relevance of the secondary markets for non-performing loans in H2 2023. These include the COVID aftermath, the Ukraine war and rising interest rates. Combined with regulatory pressure to reduce NPL exposures, EU banks are likely to be looking for ways to exit NPL positions. In this article, we examine the options available to EU banks in light of the EU NPL Directive and the disclosure templates the EBA recently published for use in NPL portfolio sales.

Key Issues

- Implementation of NPL Directive by Member States is not yet finalised and therefore its influence on the NPL market in the European Union remains uncertain.
- In light of EBA's Final Report on the new disclosure templates ("**ITS**"), EU Banks might need to reconsider their standard documentation, confidentiality agreements and internal systems.
- The ITS expand the range of exemptions available to EU Banks.

Consequences of NPLs on Banks' Balance Sheets

Numerous studies have investigated the negative consequences of high levels of non-performing loans ("**NPLs**") on the balance sheets of financial institutions. They show that, besides the pressure that NPLs are putting on individual banks' profitability, management costs and capital constraints, high NPL stocks can also exacerbate macroprudential fragilities and potentially trigger negative macroeconomic feedback loops through reduced credit supply from banks.[41]

In response to heightened NPL levels observed in a range of euro area countries, banks have made increased use of securitisations in recent years to reduce NPL stocks. As a result, NPL securitisations have quickly become an important tool in efforts to improve the soundness and efficiency of the European banking system by aligning the interest of banks, investors and public authorities. This remains true whether or not state involvement is required to make such securitisation transactions viable in the markets, as has sometimes been the case.

The NPL Directive and EBA's Final Report on Disclosure Templates

The NPL Directive

An important element of the EU regulatory structure governing the secondary market in NPLs is the EU directive on credit servicers and credit purchasers (Directive (EU) 2021/2167) ("**NPL Directive**"). The NPL Directive was approved in late 2021 but does not need to be implemented until 30 December 2023. With only months left until that deadline, most Member States have not yet implemented, leaving significant uncertainty in the detail of its requirements.

In broad terms, the NPL Directive will regulate the sale, purchase and servicing of portfolios of non-performing loans originated by EU banks. The directive is part of the EU action plan to reduce the current stock of NPLs in the EU and to prevent the build-up of that stock in the future. It aims to encourage growth of the secondary market for NPLs by improving the information available to buyers (such as pre-sale disclosure and post-sale reporting obligations)[42], reducing the regulatory impediments to non-banks buying loans across the EU, and creating a new category of authorised entity that can provide loan servicing support across the EU, all while protecting borrowers and improving supervisory oversight. However, there are signs the NPL Directive could already be affecting the market for both performing and non-performing loans as market participants prepare to comply with the disclosure, reporting, borrower protection, systems and controls, authorisation and other obligations that will apply when the new rules to be implemented by Member States take effect at the end of this year.

41 Council of the European Union, Report on the FSC Subgroup on Non-Performing Loans of 31 May 2017, 9854/17; Gattini, Luca / Gereben, Áron / Kolev, Atanas / Csonto, Balazs / Brutscher, Philipp-Bastian, EIB CESEE Bank Lending Survey H1-2014; Garrido, José / Kopp, Emanuel / Weber, Anke, Cleaning-up Bank Balance Sheets: Economic, Legal and Supervisory Measures for Italy, IMF Working Paper No. 16/135.

42 Please also refer to our December 2021 briefing entitled "*Implementing the new EU rules on non-performing loans*": https://www.cliffordchance.com/briefings/2021/11/implementing-the-new-eu-rules-on-non-performing-loans.html

The final draft ITS and disclosure templates

In addition to Member States' implementation of the NPL Directive, market participants will also need to be mindful of NPL disclosure templates drafted by the European Banking Authority ("**EBA**") for use across the EU. A final draft of those templates was published on 16 December 2022 by the EBA as part of its final draft implementing technical standards under the NPL Directive ("**ITS**"). The EBA will submit this finalised proposal to the European Commission following which the Commission will adopt the ITS (with or without amendments). The objective of the draft ITS is to facilitate comparison of NPL portfolios across EU Member States by standardising the content and format of disclosure and also to reduce information asymmetries between sellers and buyers of NPLs by ensuring a common minimum standard of disclosure. EU banks will have to provide granular loan-by-loan information to enable prospective buyers to conduct their analysis, financial due diligence and valuation of NPLs. There are sell-side concerns about the practicality of providing all this data as well as practical questions on the buy side about whether the information required by the templates will prove useful in practice.

EU banks will have to use the data templates for transfers of NPLs held in their banking book taking place on or after 30 December 2023 where the loans were originated on or after 1 July 2018 and became non-performing after 28 December 2021. However, for NPLs originated between 1 July 2018 and the entry into force of the ITS, EU banks need only complete the date templates with the information already available to them.

The ITS prescribes the use of five templates to be completed by the selling bank on a loan-by-loan basis and specify 129 data fields to be completed:

- The **counterparty template** requires the bank to provide information identifying the counterparties to the exposure, such as the borrower or any protection provider.
- The **relationship template** requires the bank to specify how each element of an NPL relates to each other element reported on, using unique identifiers. By making clear e.g. which counterparty relates to which loan, which bit of collateral is pledged to secure which loan, or which protection provider is providing each guarantee, prospective purchasers of the portfolio can better understand what they might be buying.
- The **loan template** requires disclosure of information on the loan agreement and the loan such as the cut-off date, asset class to which the loan belongs, loan currency, accrued interest or date of the default status.
- The **collateral, guarantee and enforcement template** requires disclosure of information on the type of collateral provided for the loan, in particular disclosure of specific information on mortgage guarantees.
- The **historical collection and repayment template** requires the bank to provide details of historical collections over the last three years (aggregated by month).

Despite revisions made as a result of industry consultation and designed to improve the proportionality of the templates, many of the proposed requirements still present significant challenges for EU banks, such as the mandatory disclosure of the selling bank's latest internal and external valuations of collateral (even though this will raise concerns about the selling bank's liability and its right to disclose external valuations).

In addition, the draft ITS set out the requirements for how personal data should be handled and how confidential information should be exchanged between selling banks and prospective buyers. These rules are necessary because information needed for financial due diligence and valuation of NPLs may contain elements that are confidential under applicable law, internal rules or market practices. To complicate matters further, the precise information that is confidential may vary from portfolio to portfolio depending on e.g. the type of loan, the type of obligor, or the jurisdiction(s) involved. Selling banks will therefore need robust systems in place to ensure they can identify confidential information and that it is only shared through secure channels, and subject to appropriate confidentiality arrangements (e.g. sharing confidential information only with prospective buyers who have entered into appropriate non-disclosure agreements).

Taken together, the implications of the ITS are that EU banks originating loans after – or purchasing loans originated after – the

ITS are adopted by the Commission and enter into force need to ensure that their systems can generate the information required by the templates. Additionally, they will need to consider whether their existing confidentiality agreements, and any other limitations or exclusions of liability, are adequate in the context of the new requirements. This, in turn, will depend heavily on the governing law and jurisdiction for resolving disputes elected under the relevant loan agreement.

Exemptions from the use of the data templates

EU banks who are finding compliance with the disclosure templates challenging have a range of options available to them. The ITS significantly expanded the range of exemptions available to EU banks selling portfolios of NPLs compared to the consultation draft. Notably, EU banks will not be required to complete the templates for:

(i) sales or transfers of loans that are not classified as non-performing exposures in accordance with Article 47a of Regulation (EU) 575/2013 ("**CRR**") by the selling bank at the time that the selling bank enters into a contract for the sale of the loan;

(ii) sales of NPLs as part of sales of branches, sales of business lines or sales of clients' portfolios which are not limited to NPLs and transfer of NPLs as part of an ongoing restructuring operation of the selling bank within insolvency, resolution or liquidation proceedings;

(iii) sales or transfers of NPLs pursuant to credit default swaps, total return swaps and other derivative contracts, contracts of insurance and in particular sub-participation contracts; or

(iv) sales or transfers of NPLs through securitisation where the EU Securitisation Regulation applies and the provisions of the related information is governed by the delegated and implementing regulations under that regulation (the "**securitisation exemption**").

The securitisation exemption

The securitisation exemption, however, might be of limited assistance to banks struggling with the disclosure requirements of the ITS, since the EU Securitisation Regulation currently requires NPL portfolios to do extremely detailed, templated loan-by-loan disclosure appropriate to the asset class of each underlying loan *in addition* to filling in a template of NPL-specific disclosure.

It is also worth noting that although the EBA's final draft ITS exempt NPL securitisations from the scope of the ITS and its data templates (along with some other transactions in accordance with proposed Article 2 of the ITS), that does not necessarily mean NPL securitisations escape the application of the other requirements of the NPL Directive. Although the EBA's Final Report accompanying the ITS states that the scope of the ITS and the NPL Directive should be the same, the ITS are not capable of amending the directive, which does not exempt securitisations from all its obligations.

This raises concerns and uncertainties about whether parties to an NPL securitisation remain in scope of the NPL Directive for the purposes of non-data template obligations, such as:

(i) the general obligation of the selling bank to disclose certain information to its host Member State pursuant to Article 15(2) of the NPL Directive, such as information on a creditor's rights under a loan agreement, detailed information about the credit purchaser and the type of borrower under the loan agreement;

(ii) the general credit purchasers' obligations, including the obligation to appoint a credit servicer and notify host Member States, the fair treatment of borrowers under NPLs or the appointment of an EU representative for non-EU credit purchasers; or

(iii) whether an EU bank or other entity performing credit servicing activities in relation to an NPL is subject to any of the duties imposed on credit servicers under the NPL Directive.

In addition, it is unclear whether the obligations of credit purchasers and credit servicers under the NPL Directive will apply where special purpose vehicles or other non-bank entities purchase NPLs before 30 December 2023. The Commission may address these concerns when it finally adopts the ITS or they may be clarified (ideally in a harmonised way) in the implementing measures of individual Member States.

NPL Securitisations and Recent Developments

Amendments to the EU Securitisation Regulation and the Capital Requirements

Regulation as part of the "Capital Markets Recovery Package" in April 2021[43] have

facilitated the securitisation of NPLs over the last year. These amendments defined a new category of NPL securitisations in respect of which the servicer may act as risk retainer, the size of the retention can be calculated by reference to the "net value" (taking the non-refundable purchase price discount into account) of the NPLs securitised and requirements with respect to verification of the credit-granting standards are adjusted. Taken together, these changes have made securitisation a much more viable exit strategy for NPL portfolios.

In addition, according to an empirical study of securitisations of non-performing loans from the ECB[44], the involvement of states in supporting NPL securitisations has created new NPL transaction markets. This refers to government guarantee schemes such as the "Fondo di Garanzia sulla Cartolarizzazione delle Sofferenze" (or "GACS") scheme introduced in Italy in 2016 or the "Hercules Asset Protection Scheme" (or "HAPS") introduced in Greece in 2019. It seems likely that these schemes would mainly be used where the assets could not be securitised without the involvement of the state since they are comparatively costly to banks, in terms of capital cost, deeper discounts on the assets, and the coupon demanded by private mezzanine investors. Nonetheless, there is a market for these transactions, where more complex or problematic portfolios require the involvement of a government guarantee scheme for successful market placement.

Conclusion

Before the expected increase in NPL secondary market activity towards the end of the year, EU banks will need to consider the impact on documentation they use when selling NPLs, in particular whether their existing systems and confidentiality agreements are adequate in the context of the new requirements. Because most EU jurisdictions have yet to implement the NPL Directive, uncertainty remains around the form its detailed requirements will take, whether implementing laws will be harmonised on points that are currently ambiguous and, importantly, whether the stated objectives of the NPL Directive are likely to be achieved. Additionally, uncertainty still remains around the scope of exemptions under the ITS and the NPL Directive, which hopefully will be cleared up by the Commission's final ITS and Member States' implementing measures.

43 Please refer to our March 2022 briefing entitled "*Non-Performing Loans: The Evolving Landscape*": https://www.cliffordchance.com/briefings/2022/04/non-performing-loans--the-evolving-landscape.html

44 European Central Bank: An empirical study of securitisations of non-performing loans, No 292/May 2022.

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RISK RETENTION: A RANGE OF POTENTIAL SOLUTIONS INVOLVING THIRD PARTIES

Contributors: Mark McGuire, Kevin Ingram, Maggie Zhao

It is almost fifteen years since the EU's risk retention (or "skin-in-the-game") rules were developed in response to concerns that interests of investors and originators were insufficiently aligned. In that time, the market has adapted and developed a number of solutions to adhere to the rules in situations where there may no longer be a substantial entity that was involved in the creation of the exposures to perform the risk retention function. In this article, we look at some of those solutions and the legal issues arising from them.

Key Issues

- Where there is no longer a substantial entity that was involved in the creation of the exposures to perform the risk retention function, a third party may in some cases perform the risk retention function instead.
- Approaches to risk retention in these cases will need to be carefully considered to comply with both the letter and spirit of the rules.
- Most such approaches involve such entity taking on the role as a 'limb (b) originator' due to regulatory barriers making the sponsor route less flexible and practical.

The History

When Article 122a of the Banking Consolidation Directive was adopted in September 2009, it required credit institutions investing in securitisations to ensure that "the originator, sponsor or original lender has explicitly disclosed to the credit institution that it will retain, on an ongoing basis, a material net economic interest which, in any event, shall not be less than 5%". It quickly became known as the "skin-in-the-game" rule, designed to make sure that lenders would be forced to hold on to some of the risk associated with the assets that they originated, in the hope that this would incentivise the securitisation of high-quality assets. The rules have been updated a number of times since then (mostly to expand the scope of entities caught by the rule), but the substance of the 5% requirement has remained broadly intact. However, the relative stability of basic requirements belies the steady change in compliance methods that have been seen in the market over the years.

By and large, these developments were borne out of a need to apply existing rules to novel situations. It quickly became clear that there were multiple portfolios in need of financing via securitisation where there was no longer a substantial entity that was involved in the creation of the exposures, and so no obvious single candidate to fulfil the role of 'originator' or 'original lender'. In other cases, the portfolio was held by complex or thinly capitalised entities (such as some funds) that might not be considered entities of substance for the purposes of the rules. Faced with these circumstances and the need to adhere to the letter and spirit of the rules, the market gradually developed new ways of thinking about which entity could hold the risk retention piece in a compliant manner. We set out some of the methods that we have seen in the market, and explore the legal issues arising from them, below.

Who Can Be an 'Originator'?

The term "originator" is defined in Article 2(3) of the EU Securitisation Regulation and Article 2(3) of the UK Securitisation Regulation as "*an entity which:*

(a) *itself or through related entities, directly or indirectly, was involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposures being securitised; or*

(b) *purchases a third party's exposures on its own account and then securitises them;*"

Limb (b) has garnered the most attention, particularly, where the original creditor of the exposure is not involved in the later securitisation.

The key legal issue here revolves around what it means for an entity to purchase exposures "on its own account". None of the UK Securitisation Regulation, EU Securitisation Regulation nor any of their corresponding guidance define the term "for its own account". There is, however, a helpful analogy with the concept of "dealing on own account" under Article 4(1)(6) of the Markets in Financial Instruments Directive ("**MiFID**"), being the

activity of "trading proprietary capital resulting in the conclusion of transactions in one or more financial instruments". In the context of MiFiD, that would be contrasted with "executing orders on behalf of clients", i.e. acting as a riskless intermediary. With this in mind, we can therefore consider a few methods for identifying an entity that can appropriately be a "limb (b) originator".

The purchase method

It is possible for an entity to be regarded as a "limb (b) originator" as long as it is exposed to the risk of the exposures on a principal basis. There is no suggestion in the text to support any assertion that the originator must become the 'lender of record' under the terms of the underlying exposures. To that end, the purchase of the beneficial interest in the asset portfolio is sufficient to show that the entity "purchases a third party's exposures on its own account" and could therefore be deemed a limb (b) originator, whether or not such purchase is perfected by giving notice to underlying obligors.

There are also other practical issues to consider. If an entity is to be deemed a limb (b) originator, it must be the entity who "securitises" the exposures. As such, that entity would typically be expected, either itself or through its agents, to instruct the creation of the issuer special purpose vehicle and other third parties such as rating agencies. It would also typically need to carry out suitable due diligence on the underlying exposures and, in the case of public securitisations, be involved in the marketing of the deal to investors. Any would-be limb (b) originator must therefore be willing and capable of performing these roles.

The commitment method

An entity can be considered to be a limb (b) originator even if the exposures are not "purchased" in the entity's own name, either legally or beneficially, as long as the entity acquires the risk associated with the exposures. Practically speaking, you would normally expect to see this risk reflected on the balance sheet (both for accounting and regulatory capital purposes), particularly for regulated entities. The term "purchases" (as used in Article 2(3) of the Securitisation Regulations) is widely viewed in the market as a requirement that a limb (b) originator be exposed to the credit risk of exposures it is transferring into a securitisation scheme, rather than being restricted to a "purchase" in the technical legal sense. For example, if a regulated entity is required to post regulatory capital in respect of the risk associated with a pool of exposures, that entity is clearly "on risk", irrespective of whether any legal or beneficial title has passed to that regulated entity.

For example, the entity intending to act as limb (b) originator could generally be considered "on risk" from an accounting perspective as of the time that entity was committed (with little or no conditionality) to purchase the relevant exposures at a particular price, perhaps by way of a binding commitment letter. The full sale documentation need not necessarily be finalised or executed at this time, and the actual legal purchase of such exposures need not necessarily have completed. This could be the case as long as such entity remains exposed to the financial risk in the period between its commitment becoming effective and the completion of the sale of the exposures.

In particular, there should be no mitigant or ability for the putative buyer to back out based on the exposures' performance in the interim period (for example, a market out or a mechanic adjusting the purchase price based on the exposures' performance as at the transaction closing date). Moreover, the commitment to purchase should not be conditional upon the securitisation taking place, meaning the putative buyer assumes the associated execution risk.

The commitment to purchase can include a mechanism under which the on-risk entity acting as limb (b) originator may procure that the loans are legally purchased on its behalf by a third party nominated by the entity. This might be useful if there are legal barriers to the entity acting as limb (b) originator holding legal title to the exposures (e.g. a statutory requirement under the governing law of the exposures requiring the lender of record to be an entity in the jurisdiction). When the sale takes place, the loans may pass straight from the seller to the acquisition vehicle, which may be the securitisation SPV.

The result is that an entity can act as a limb (b) originator without ever having had legal ownership of the underlying exposures (although it must have borne credit risk associated with them). Despite this, the requirement for the originator to "securitise" the exposures nonetheless means that the entity must play a key role in the securitisation transaction. It would therefore still need to be instrumental in bringing the deal to market. For this reason, many entities looking to act as limb (b) originators in the public securitisation market have held roles as arranger or manager on the related securitisation.

The historic portfolio risk method

More recently, the start of the "on risk" period for the entity seeking to act as limb (b) originator has been treated by some market participants as beginning on the last day on which the proposed limb (b) originator has knowledge of the portfolio. If the entity is not supplied with up-to-date information on the portfolio performance after a particular date – we'll call this the "Cut-Off Date" – but they go on to commit to buy the portfolio anyway, the logic is that they will be taking the economic risk of any poor performance that may have occurred from the Cut-Off Date and not just from the date they become bound by the commitment. In other words, they will acquire retrospective risk on the portfolio for their own account.

This approach might be preferred by some entities. If the entity can be regarded as being "on risk" as of the Cut-Off Date, finalising a commitment to purchase well in advance of the securitisation becomes less important. This means that the commitment to purchase can be made much closer to the securitisation closing, potentially after the securitisation has priced, albeit it remains crucial that the entity is "on risk" prior to the securitisation closing. When contrasted with the 'purchase method' or the 'commitment method' above, both of which require the entity to disregard the viability of the securitisation going ahead, this 'historic portfolio risk' method is more closely tied to the progress of the securitisation if there is no commitment to purchase until the transaction has priced – thereby drastically reducing the execution risk taken by the limb (b) originator. It also has the advantage of reducing the period of time for which the relevant entity may need to bear any related regulatory capital costs.

From a practical perspective, however, this method can be slightly more difficult to implement. It is of the utmost importance that the entity is not able to act on any information relating to the portfolio after the Cut-Off Date, which in some cases can cause obstacles if the relevant entity or its affiliates have a role in marketing the securitisation. This method is also less 'tried and tested' than the purchase method or the commitment method, so it is not clear how regulators will feel about it. However, it has been used on a number of public transactions, and is based on the same fundamental principles as the other methods – namely, the limb (b) original entity being on risk for its own account prior to the securitisation taking place.

How long must the entity be "on risk"?

One question that frequently arises is how much time must elapse between the entity first being "on risk" and the securitisation taking place. There is not a single rule here, and none of the relevant legislation or guidance specifies a particular holding period. The answer largely depends upon how the entity's risk manifests itself.

For example, if the risk is demonstrated by a regulated entity posting regulatory capital against the risk, this provides strong evidence that the entity has been "on risk" even if capital has been posted for a relatively short period. If the risk is demonstrated by way of frequent mark-to-market valuations with consequential regulatory reporting costs, evidence that the entity has been "on risk" can be derived from fluctuations in the price.

If the intention is to demonstrate the risk solely by the entity taking on the risk of the underlying exposures falling to pay when due, care must be taken to ensure the risk being taken is real and not illusory. For example, if the underlying exposure consists of a large loan repayable by instalments, and the period the proposed limb (b) originator is "on risk" does not include any payment dates on that loan, there is no real possibility of the asset suffering a default during that time and the risk taken is largely theoretical.

What About Acting as a 'Sponsor'?

No matter which of the above three methods are considered, structuring a transaction so that an entity involved in the creation of the exposure can reasonably be considered to be an "originator" requires a considerable amount of upfront thought and documentation, as well as the would-be originator's willingness to bear the economic risk associated with the exposures. In some cases, it can appear simpler for the risk retention holder to instead act as a "sponsor" instead.

There are, however, significant regulatory reasons why this is impractical, since acting as a sponsor is restricted to certain types of institutions (generally credit institutions and investment firms) and there are greater difficulties with cross-border recognition of sponsors because of licencing requirements (e.g. a UK investment firm would not be recognised as a valid sponsor in the EU if it did not also hold an EU MiFID authorisation).

Assuming those regulatory barriers are not an issue, both the UK Securitisation Regulation and the EU Securitisation Regulation require that a sponsor "establishes and manages" a securitisation transaction, or establishes a securitisation and delegates the day-to-day active portfolio management involved in that securitisation to an entity authorised to perform such activity.

For a proposed sponsor that was intending to act as an arranger, the "establishes" limb can often be met with relatively little additional work. The second limb of "manages" can be more difficult, as it would require ongoing involvement in the transaction after the distribution of the relevant notes: something many arrangers prefer to avoid. That ongoing management role would likely comprise two strands. The first such strand is a management function in respect of the exposures. In a static pool, this could be achieved by acting as servicer, or exercising some form of influence over the servicer's decision-making, such as participation in a committee or having defined consultation rights. In an actively-managed pool, the sponsor would generally be expected to have a significant role in the relevant investment decisions. The second strand is management of the transaction structure beyond the securitised exposures, particularly with respect to the transaction's liabilities: this could include acting as cash manager or paying agent, or taking on a role in addressing queries from investors.

In the current market, it is more common for risk retention entities not involved in the creation of the exposures being securitised to act as limb (b) originators than as sponsors. However, the sponsor option remains open to market participants, and may be the most logical route to follow in certain circumstances – in particular where an obvious candidate to take on the role of 'limb (b) originator' exists but for any reason does not wish to hold the risk retention itself.

The Future

When the risk retention rules were first developed, there was a great deal of anxiety about how the rules would affect the market and whether securitisations could be rendered impossible in certain circumstances. While some concerns remain, the ability of the market to adopt new approaches in compliance with the letter and spirit of the regulations has ensured that securitisation remains a viable route to raising capital against a wide range of portfolios. However, the rules can function as traps for the unwary, and their requirements are not as black-and-white as they may first seem. As the market continues to grow accustomed to the new regulations (including applicable technical standards and regulatory guidance), and newer transactional solutions arise, we fully expect to see further, deeper and richer analysis being undertaken and new structured solutions being considered by market participants – but any such approaches will need to be carefully considered.

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FORWARD FLOW SECURITISATION: THE RIGHT TOOL FOR THE RIGHT JOB?

Authors: James Watkins, Chris Walsh, Maggie Zhao

Developments in forward flow securitisation have made it a popular financing tool for originators looking for funding certainty while the public markets remain turbulent. Removing assets from the balance sheet or leveraging them at origination can be a significant benefit. In this article, we look at the benefits as well as a number of issues that can make transactions of this type complex and commercially sensitive.

Key Issues

- Forward flow securitisation and wet-funded warehouse securitisation can be useful tools in turbulent markets.
- Advantages include long term funding certainty, balance sheet optimisation, and increased returns.
- But forward flow transactions require participants to deal with complex issues around control, future credit risk and regulatory compliance.
- A well-constructed forward flow securitisation based on 'relationship lending' can bridge the gap between unsecured debt and a full asset-backed financing.

What is Forward Flow Securitisation?

The traditional securitisation funding model for originators is to originate a portfolio of assets, funded by a combination of equity and corporate debt, and then to securitise those assets. They might be securitised through a private 'warehouse' transaction – where they will be held by a special purpose vehicle ("**SPV**") financed by a combination of senior (and sometimes mezzanine) debt provided by external funders and junior debt provided by the originator. Alternatively (or later on) they might be securitised through a public bond issuance, funded by public market investors (and, more recently, direct investors through pre-placement or loan note tranches).

As an alternative, some originators engage in forward flow securitisation, where assets are originated and sold to external funders on origination. The asset is removed from the originator's balance sheet, putting the funder entirely on risk for the asset's performance. The economic benefit of the transaction for the originator derives from fees for origination and servicing of the assets, while the funder gets the benefit of excess returns over funding costs. This leads to the possibility of higher profits for the funder than can be achieved by taking a senior or mezzanine position in a private or public securitisation. Funders may further leverage these types of transactions by adding senior (and sometimes mezzanine) finance.

More recently, a popular tool for originators looking to secure funding has been the forward flow or 'wet-funded' warehouse securitisation, combining the private warehouse transaction with forward flow techniques. In this type of transaction, external funders provide the originator with 'wet funding': money transferred to the originator to fund the origination of assets which are securitised through an SPV on origination.[45] In legal terms, this is often characterised as an advance payment of purchase price for the sale of the assets originated by the originator and immediately transferred to the SPV. However, some origination platforms are instead structured such that the assets are originated within the SPV itself. Again, these types of transactions may be leveraged by adding senior and mezzanine finance.

Why Use Forward Flow Securitisation?

Forward flow and wet-funded warehouse securitisation can be a very useful tool for originators and funders in certain circumstances.

Benefits for originators

For originators, the traditional securitisation funding route of establishing a private warehouse transaction to hold assets until an appropriate time to carry out a public bond issuance has been disrupted by recent turbulence in the public markets, driven largely by increases to – and uncertainty around – interest rates, and the lack of appetite from public investors for asset-backed securities. Many originators need a consistent stream of external funding to pursue their business objectives. Holding assets on balance sheet without finance in these circumstances is not an option. In this environment, forward flow and wet-funded

45 As opposed to 'dry funding', funding to purchase assets that have already been originated, used in the traditional private/public securitisation.

warehouse securitisations, or a combination of these tools, can offer originators long-term certainty of funding to continue to develop business lines, usefully filling the gap between unsecured debt and fully securitised asset-backed debt.

True forward flow securitisation, in particular, can also be a very useful tool for managing the originator's balance sheet. As assets are sold on origination in whole to the funder, they can be immediately derecognised from the originator's balance sheet, allowing capacity for ongoing origination. Similarly, wet-funded securitisation can allow originators to leverage assets on creation, making funding costs significantly leaner by reducing the need to fund origination initially through equity or other corporate debt.

As we explain further below, forward flow securitisation can, in some circumstances, also allow originators to avoid onerous securitisation regulatory requirements by avoiding the creation of a "securitisation" for regulatory purposes.

Benefits for funders

For funders, forward flow securitisation can be a way of gaining exposure to certain asset classes without the need to develop their own origination and underwriting capacity or to meet consumer lending requirements. This has been particularly evident in the fintech sector, where online lending platforms have become a popular way of delivering finance to end-consumers matched by investment from non-bank lenders, with significant returns available both to the platform (through origination and servicing fees) and to the funders (through excess spread). In this respect, see the article entitled "*Speciality Financing Platforms: connecting borrowers and lenders globally*" later in this volume.

Certain kinds of financial institutions, particularly cash-rich deposit taking institutions, might also achieve regulatory capital benefits by holding an investment in assets rather than, for example, an exposure to a securitisation. Forward flow and wet-funded warehouse securitisations can also be a way for funders to develop and cement relationships with their clients by ensuring long-term involvement in product and business development.

Key Issues in Forward Flow Securitisation

However, forward flow and wet-funded warehouse securitisations present a number of unique issues and concerns in addition to the usual commercial focuses of asset-backed finance. In both the typical forward flow and the wet-funded warehouse securitisation, the key differentiator for the funder from the traditional warehouse or public securitisation model is that the funder is taking more risk on the origination business itself. This means there needs to be much more focus on the originator's business plan and historic performance than on the assets underlying the securitisation.

In turn, this means that transactions of this type tend to feature stricter controls over the originator, the origination process and the assets to be funded (through eligibility criteria and concentration limits). Parties also need to be aware of the implications of funding a future portfolio of assets, by taking steps to mitigate future interest rate risk, including through hedging strategies, and ensuring an appropriate exit route. Finally, funders and originators need to take care to ensure that the transaction fits within applicable regulatory parameters, notably consumer regulation and the securitisation regulatory regime.

Control over the originator

For the reasons just outlined, these transactions typically feature increased focus on the controls over the originator and the origination process. Common areas of concern are the origination documentation and credit and collection policies and ongoing business performance.

Origination documentation and credit and collection policies

Forward flow and wet-funded warehouse securitisations typically include extensively negotiated covenants around amendments to the origination documentation and credit and collection policies. Originators will be looking to retain freedom to operate their business flexibly and without onerous approval processes (particularly where requirements to make changes might come suddenly and result from regulatory or legal pressures). On the other hand, funders want to know what they are getting as assets are originated, so they will seek approval rights for changes that could affect the credit quality of the assets. They will also want to ensure that they are not being exposed to regulatory risk, for example by monitoring, and ensuring they have approval rights in relation to the originators' proposals to change origination documentation and credit and collection policies to comply with applicable law. Covenants like these continue to be put under increasing stress as national and international crises like the COVID-19 pandemic, and regulatory responses to those crises, require originators to act quickly to make changes for consumers.

Credit policies are also a key area for diligence and negotiation, with funders looking for control over pricing strategy to ensure coverage for funding costs or to improve returns. There is frequently tension here, with some funders (typically bank lenders) being institutionally sensitive towards products with high costs or interest rates for consumers, while financial investors are more comfortable supporting the origination of non-conforming and subprime assets.

Business performance
Funders will also be looking to monitor the ongoing business performance of the originators, and this is commonly in the form of audit covenants. The usual topics of negotiation are frequency and scope. Funders may want to involve external auditors, which can cause significant operational pressure on originators complying with requests for information and access, while originators will want to limit audits to predictable and, ideally, infrequent occasions. Funders may also want to ensure they have a secure exit route, by performing audits on the assets to verify that they are of a good enough quality to be suitable for public securitisations. There is also likely to be negotiation around who bears the cost for audits, with originators arguing that funders, or the transaction itself, should meet these costs, while funders might look for cost coverage from the originator. Some transactions might see the responsibility for meeting costs change depending on whether someone is at fault.

Borrowing bases, eligibility criteria and concentration limits

In forward flow and wet-funded warehouse securitisations, control over asset quality and credit exposure is controlled primarily via a combination of:

- **eligibility criteria:** which determine which assets are eligible to be purchased and funded; and
- **concentration limits:** which determine how much of the portfolio can consist of assets in certain categories or with certain common features.

Together, these typically define what is referred to as the borrowing base – the portfolio of assets that are eligible for funding. The funder will then apply an advance rate (essentially a percentage discount) to the borrowing base to determine the limits of its credit exposure.

Credit given to collections
A key topic of negotiation on the borrowing base is the ability to fund future asset generation and, in connection with that, what credit is given to collections received on existing assets. Originators and funders often have a keen focus on whether collections received form part of the borrowing base, such that it can be borrowed against and used to generate more assets. Failing that, originators would need to wait until that cash is used to repay debt before it can be reborrowed. Originators are often successful here; it is a fairly straightforward argument to convince a funder that cash in the bank is suitable security. More sophisticated originators may even push for netting arrangements, where they only need to sweep collections to the funder on a periodic basis, and they can do so net of cash used for new origination. This can be a more difficult fight, because it requires funders to take commingling risk on intra-period collections.

Concerns for funders
Different types of funders are likely to have different risk appetites. In a leveraged forward flow or wet-funded warehouse securitisation, the equity investor is likely to have a different perspective on eligibility criteria and concentration limits to the senior funder. The equity investor may be comfortable to take more risk on less credit-worthy assets to generate higher returns, but less happy to take risk on tax issues which would affect the equity investor before the senior funder. A senior funder may have very specific limits on its credit approval, or be looking for exposure to very specific assets, and therefore have limited scope for negotiation. This could mean wanting to limit assets to certain geographic regions or credit qualities, or certain asset types (for example, in the context of residential mortgage securitisation, only one of owner-occupied or buy-to-let). As discussed above, there are can also be tension over pricing strategy, with funders having varying levels of appetite for exposure to non-conforming or high interest rate assets.

Mitigating interest rate risk

As interbank rates continue to fluctuate and increase, one of the key concerns and pressures on asset-backed financing is the need to mitigate interest rate risk. This can be particularly complex for forward flow securitisation, where the ultimate composition of the portfolio (including the weighted average interest rate of the fixed rate assets) might not be known at the start of the transaction or indeed ever. Many originators are having difficulties here, as portfolios of assets generated during low interest periods might be incapable of supporting market pricing for securitisation debt when those assets later come to be securitised.

Forward flow securitisations therefore typically use a range of different tools to control interest rate exposure. These include:

- eligibility criteria and concentration limits intended to keep the weighted average interest rate of the fixed rate assets above an agreed percentage;

- excess spread triggers, where the returns are required to be maintained at a certain threshold over funding costs;
- hedging triggers, where originators are required to put hedging in place if there is a risk that the asset portfolio will not be able to support an increasing interest rate on the liabilities or where interbank rates exceed an agreed rate; and
- 'pre-hedging', where originators agree mechanics to put in place interest rate swaps at the point of asset origination, rather than using a retrospective test to ensure compliance with hedging requirements.

Pre-hedging

Pre-hedging has become increasingly popular and can lead to significant complexity. Typically, this involves interest rate swaps being entered into when assets are offered to consumers for origination, either on an asset-by-asset basis, or based on small pools of assets, to mitigate interest rate risks on those assets or pools. This enables originators to get certainty over their funding costs at the point the offer is made to the consumer. When the assets are originated and sold into the securitisation, they are transferred with the economic benefit of the related interest rate swap (e.g. by novation). This offers both the originators and the funders certainty over the debt service that the portfolio can support (because fixed rate assets are essentially turned into floating rate assets on origination).

However, mechanisms like this can be particularly difficult to model, as they are impacted by, among other things, customer trends, origination patterns, and expected prepayments. Originators wanting to use these mechanisms will therefore need sophisticated approaches to continually monitor the shape of the securitised portfolio, their expected asset generation and completion success rate, and the funders' hedging requirements, to avoid costly risks. For example, because the interest rate swap is traded at the point of offer rather than origination, a high rate of failure to convert offers into assets could lead to significant hedging costs with no assets to meet them.

For swap counterparties, who have traditionally provided either vanilla interest rate swaps or balance guaranteed swaps for securitisation transactions, meeting the operational demands of increasingly frequent and granular swap transactions can be difficult.

Exit strategy

In a traditional private warehouse securitisation, the typical exit strategy is a refinancing by way of public securitisation, often referred to as a "public take-out". Warehouses will contain a call option to enable this by allowing the originator to repurchase all the assets or arrange for their disposal to an SPV. The warehouse therefore allows the originator to accumulate assets until they have sufficient assets available to support a public transaction, while retaining ultimate control over the assets.

In the forward flow securitisation model, where the entire beneficial ownership of the assets is transferred to the funder, a public take-out may still be a viable route for the funder to refinance its exposure to the assets, but the originator's only involvement is likely to be as servicer of the assets. This means that the originator has far less control over the shape of the resulting public securitisation, will not be able to benefit from the cheaper funding costs available from the public market, and is therefore less incentivised to participate in the public take-out. For originators with multiple forward flow securitisations, they will need to take care to avoid reputational issues involved in having multiple public take-outs occur within a short time period. To this end, they might be able to negotiate clear markets provisions with funders. Options for managing other reputational risks are limited. For example, they may be unable to ensure public pricing consistency given their lack of control over the assets.

Wet-funded warehouse securitisation can offer originators the best of both worlds, by allowing them to retain control over their assets (through funding the junior debt in the securitisation and holding a call option) while they accumulate. Originators should note, however, that senior funders of these types of transactions typically insist on measures to ensure their involvement in the resulting public take-out. This is often a combination of:

- a prepayment fee payable to the senior funder for terminating the private securitisation early;
- an agreement by the originator to give the senior funder a right of first refusal for any arranger/lead manager role in the public take-out; and
- an agreement by the senior funder that the prepayment fee will be reduced by the amount of any arrangement/ management fees paid to it as part of the public take-out.

Consumer duty

Forward flow securitisation has often been used as a route for non-bank and unregulated financial investors to gain exposure to regulated products. By leaving the origination process in the hands of a regulated lender, the unregulated financial investor can acquire the credit risk of the assets without the need itself to be regulated.

However, the UK Financial Conduct Authority's new consumer duty (the "**Duty**"), which comes into force on 31 July 2023 in relation to new and existing products or services that are then open to sale or renewal, risks disrupting that approach. Broadly, the Duty will introduce a new consumer principle, requiring firms to "act to deliver good outcomes for retail customers". This applies to both manufacturers and distributors of products marketed or distributed to retail customers. The FCA has explained that the concepts of manufacturer and distributor are "*deliberately broad to capture all aspects of the manufacture and distribution of products and services*".[46] There is therefore a real risk that a non-bank lender transacting with a regulated lender in creating a product for the purposes of forward flow securitisation is within the scope of the Duty (even if they are not regulated for other activities).

This has seen funders take steps in transaction documentation to limit the perceived control they are exercising over the products and the relationship with customers. Naturally, this is a source of tension, particular in light of the concerns over control over the origination process and documentation that we outlined above. Alternatively, some funders are accepting that, in certain scenarios, being within scope of the Duty is unavoidable, in which case a co-manufacturing agreement might be required. For more information on the FCA consumer duty, see the article entitled "*The FCA Consumer Duty: practical implications for market participants*" earlier in this volume.

Risk retention

The traditional model of forward flow securitisation offered originators the opportunity to bypass regulation that applies to securitisation transactions. In a whole-loan sale forward flow securitisation, where the entire economic benefit of the originated assets is sold to the funders and the originator has no ongoing exposure to the credit performance of the assets, it is likely that there is no securitisation for the purposes of the EU and UK securitisation rules. Accordingly, originators can avoid the onerous risk retention, transparency and credit-granting requirements that apply under those regimes.

Common issues for wet-funded warehouse securitisation

For the hybrid, wet-funded warehouse securitisation model, where originators are retaining a junior credit risk in the transaction and therefore there is likely to be a securitisation for regulatory purposes, originators and funders will need to take care that regulatory requirements are met. While these kinds of transactions do not inherently present difficulties, the fact patterns that make them a viable source of funding can coincidentally present regulatory issues. For example, originators developing assets solely for the purposes of securitising those assets through a forward flow or wet-funded warehouse securitisation might have to consider carefully the requirements around credit-granting, and applying the same criteria to securitised and non-securitised assets.

Similarly, originators creating new origination platforms might need to consider in advance whether their proposed risk retaining entity is an entity of substance capable of passing the "sole purpose" test. Regulatory developments over the last year, in particular the consultation regarding the final draft risk retention regulatory technical standards ("**RTS**") under the Securitisation Regulation (EU) 2017/2402 ("**EU Securitisation Regulation**") and the changes made to the those draft RTS from the previous drafts make clear that the sole purpose test, and the use of thinly capitalised vehicles as risk retainers, is still a focus for regulators.

Equity investor risk retention

More recently, a popular alternative model has been for the equity investor in a leveraged forward flow or wet-funded warehouse securitisation to be the risk retainer. This might be because the originator has no appetite to retain risk. Here, the regulatory issues typically centre around finding the correct characterisation for the equity investor as an eligible risk retainer. Broadly, the EU Securitisation Regulation (and its UK equivalent) have two routes for equity investors in this scenario: be an eligible risk retainer either by being involved in originating the assets, or by purchasing a third party's assets on its own account and securitising them.

For transactions involving the purchase of assets by an SPV from the originator (including wet-funded warehouse securitisation's involving an advance payment of purchase price as wet funding), the latter route can be the obvious choice. Concerns around whether the assets were truly purchased by the equity investor "on its own account" and then securitised can be allayed by the equity investor giving a commitment to

46 FCA, *A new Consumer Duty: Feedback to CP21/36 and final rules* (PS22/9, July 2022), 20: https://www.fca.org.uk/publication/policy/ps22-9.pdf

fund the SPV and the SPV giving a commitment to purchase assets from the originator.

Where the transaction does not involve the purchase of assets, for example where the assets are originated in the SPV, typically the equity investor must find a way of being comfortable that it was involved in the origination process. This might be a combination of being related to the SPV (as a shareholder, for example), negotiating the terms of the transaction and the underlying assets (including eligibility criteria and concentration limits), and performing due diligence on the origination documentation and the originator's credit and collection policies.

The Right Tool for the Right Job?

In the right circumstances, forward flow and wet-funded warehouse securitisation can be an incredibly useful tool for achieving originators objectives in challenging market environments and allowing funders access to otherwise unavailable exposures. A well-constructed forward flow securitisation is a true relationship lending transaction, where the relationship between the originator and its trusted financial institution is at the heart of the commercial negotiation. But originators and funders should take care to work through the number of complex commercial and legal issues at the heart of these transactions to make sure they are meeting their goals.

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SPECIALTY FINANCING PLATFORMS: CONNECTING BORROWERS AND LENDERS GLOBALLY

Contributors: Simon Connor, Anna-Lena Marx, Jacklyn Hoffman, Gareth Old, Simeon Radcliff, Maggie Zhao

The importance of specialty financing platforms continues to grow, connecting debtors and funders across the globe at increasing pace and scale. In this article, we explore how speciality financing platforms deploy different legal techniques to create sophisticated and robust investment opportunities for varied markets, facilitating previously untapped lending opportunities and helping to significantly narrow the existing trade finance gap.

Key Issues

- Varied speciality financing platforms continue to play an important role in the market, including plugging the USD 1.7 trillion trade finance gap.
- Platforms deploy different legal techniques to create sophisticated and robust investment opportunities to (often) untapped markets.
- Opportunities to interpose financing solutions into the global supply chain (using embedded finance, digitalisation and automation) continue to advance at pace.
- Borrowers and investors (as lenders) can be "matched" through speciality financing platforms.

Introduction

Over the course of the last five to ten years, a large variety of specialty financing platforms have taken a foothold in the market. These platforms provide financing for a wide range of product and asset classes – including trade receivables, corporate loans and consumer loans/ leasing. They therefore attract a large and varied borrower base (principally consumers and small and medium-sized enterprises) and a diverse set of investors. The investors range from traditional banks to private equity investors, asset managers, funds and insurance companies. At the same time, peer-to-peer lending ("**P2P**") is becoming increasingly popular, enabling consumers to obtain financing directly from other consumers thereby removing banks and financial institutions as the linchpin – although many of the leading fintech platforms that initially raised funding via the P2P model now also raise funds via the capital markets, often using structured finance techniques (whether securitisations, originator trust structures or similar arrangements). The emergence of these platforms streamlines the process of obtaining finance across jurisdictions. They allow for global growth by connecting potential borrowers to investors and enabling the production and delivery of goods and services across the globe, which, in turn, catalyses economic growth.

Wide Variety of Specialty Financing Platforms

Specialty financing platforms have evolved significantly over the course of the last decade. Some players started out with less complex financing arrangements and then increased the complexity and jurisdictional reach of their platforms to achieve further efficiencies, scalability and a wider investor base. One common feature of speciality financing platforms is that they are often thinly capitalised. The platforms do not necessarily have the capital nor the desire to fund the acquisition of assets on their own balance sheet. Instead, raising capital from third party investors (often allowing investors to gain an exposure to the underlying assets on a "pass through" basis) is commonplace. The legal solutions employed to ensure that investments made using these platforms have an acceptable level of "legal security" are sophisticated and varied.

Some platforms use a sophisticated factoring (or reverse factoring) model. Borrowers (in the context of loans) and debtors and/or suppliers (in the context of trade receivables) sign up to the relevant platform dependent on passing thorough know-your-customer checks done by the platform. Stand-alone independent payment undertakings are also sometimes granted by the borrowers/debtors as part of the onboarding process. In those undertakings, they agree (either via a supplemental arrangement or through a modification to the terms of the underlying loan/receivables contract) that they owe the debt directly to the investor. That debt may be acquired by (i) the investor, directly onto its balance sheet or (ii) a special purpose vehicle, which, in turn, is financed by the investor or a syndicate of investors. In the latter case, the debt would normally be wholly secured in favour of the investor(s), who would sometimes also share in the upside of any excess cashflows.

An alternative to these (reverse) factoring structures are originator trust structures. Originator trusts have recently been deployed through financing platforms focussed on providing financing in the context of consumer loans, the Coronavirus Business Interruption Loan Scheme ("**CBILS**") and the Recovery Loan Scheme ("**RLS**"). Originator trust structures are typically used where there are concerns around the assignability of assets – or the assignability of the benefit of a guarantee, as was the case in respect of the UK government guarantee issued in the context of CBILS and RLS.

Alternatively, some speciality finance platforms effectively "match" borrowers with investors (as lenders). In these cases, the platform typically charges a fee for origination and servicing activities.

The variety on the asset side is matched by a variety of investment types. Investments in platforms can take the form of loans, notes, loan notes or New York-style participation agreements, and can be structured as securitisations (for EU, UK and/or US regulatory purposes) or structured not to be a securitisation, as needed. The variety of financing platforms in the market deploying different funding models means there is increasing flexibility for borrowers, debtors, suppliers and investors in terms of borrowing and investor funding methods, and the related platform's structures and features.

Trade Finance Platforms and the Opportunity to Narrow the Trade Finance Gap

The trade finance gap is the excess of demand over supply for trade finance. The Asian Development Bank estimated that in 2020, the "*value of trade finance transactions supported by major global banks was (…) around USD 9 trillion*"[47] with the "*trade finance gap (…) [being] at an all-time high, having reached $1.7 trillion (…).*"[48] Specialty finance platforms are well-placed to narrow this gap – especially given the plethora of models available. While trade finance has traditionally been supported by banks, platforms with a wide variety of investors are moving into this space to provide finance where banks historically haven't and bridge the trade finance gap.

One of the market-leading UK trade finance platforms seeking to narrow this gap is Stenn. In 2019, Stenn established a multi-jurisdictional trade receivables securitisation platform backed by trade receivables and wrapped by credit insurance with advice being provided by, among others, Clifford Chance. Stenn acquires these trade receivables as part of their own invoice financing and factoring business from suppliers or other third party factoring companies (and owed by debtors) across the globe. This transaction was unique by virtue of Stenn itself being a factoring company. It therefore requires simultaneous funding via the securitisation to match its origination. This meant using a dynamic pre-funding mechanic and the ability to sell receivables to the issuing SPV daily, thereby providing Stenn with frequent cashflows to facilitate efficient origination through its own acquisition of the relevant receivables immediately prior to on-selling to the SPV. Stenn's trade receivables programme is truly global with obligors, suppliers and intermediary factors located in more than fifty jurisdictions. Detailed legal, insolvency and tax analysis has been undertaken in almost half of the jurisdictions to date.

The US enterprise resource and working capital management specialist Taulia LLC has also established a number of trade finance programmes to narrow the trade finance gap. Using versatile special purpose entities in Europe and the United States, Taulia established first a supply chain finance programme with the capacity to form segregated series from time to time to acquire receivables and payment undertakings from sellers and obligors who participate in Taulia's SCF Program. Those supply chain finance programmes were subsequently augmented by account receivable purchase facilities. While the European programme is a traditional Luxembourg-based securitisation vehicle issuing single-tranche asset-backed securities to investors, investors in Taulia's US trade finance programmes acquire participation interests in the receivables and payment undertakings owned by the US vehicle. Taulia's trade finance platform is scalable both by virtue of its structure and its link to the Taulia technological platform, while achieving optimal funding efficiency without the issuance of securities. Clifford Chance is pleased to be involved as counsel to Taulia on the establishment and ongoing development of its US trade finance programme.

Financing Platforms – what's next?

Credit insurance has been, and continues to be, a hot topic and we expect to see credit insurers continuing to underwrite debtor default risk in financing platforms. This offers credit enhancement and broadens the pool of potential financiers.

47 Asian Development Bank: https://blogs.adb.org/blog/your-questions-answered-what-trade-finance-gap-and-why-does-it-matter and see also: https://www.adb.org/sites/default/files/publication/739286/adb-brief-192-trade-finance-gaps-jobs-survey.pdf

48 S&P Global: https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/banks-risk-widening-trade-finance-gap-as-they-push-for-green-label-72221977

This is because some financiers require credit insurance recourse for investment and/or regulatory capital purposes.

In the United Kingdom, the Electronic Trade Documents Bill is currently being considered in the House of Commons which, if passed into law, will allow for the legal recognition of electronic trade documents such as bills of lading and bills of exchange. This would likely enable financing to be raised at an earlier stage (and ultimately with more legal certainty) than is currently the case during the supply chain life cycle, to the benefit of all interested parties.

Given continued focus on environmental, social and governance ("**ESG**") objectives and the exposure of some of these financing platforms to the bond market, financing platforms may be well-positioned to drive ESG objectives by requiring the underlying borrowers, debtors and/or suppliers to meet certain ESG minimum requirements when borrowers, debtors and suppliers sign up to the platforms. However, given the uncertainty surrounding standardisation of ESG criteria, we expect more time is needed before the precise role financing platforms can play becomes clear. For more information, see the article entitled "*ESG Securitisation: weathering the storm?*" earlier in this volume.

Regulators, including the Financial Conduct Authority in the UK, have also highlighted heightened fraud risk in the trade finance business and have encouraged market participants to conduct detailed know-your-customer checks. Market participants note, however, that no seismic shift has taken place following these announcements by regulators, which is likely because significant borrower and debtor due diligence has always been a key focus of sophisticated platforms and the funders financing them.

Despite the demise of Greensill, trade finance platforms have continued to be popular with other players in the market seemingly picking up market share, including UK-based Stenn, San Francisco-based Taulia (both mentioned above), New York-based LiquidX and Missouri-based C2FO, with some market participants observing that given the wide variety and number of platforms, consolidation is expected over the coming years.

Given that financing platforms can effectively provide a direct liquidity line to underlying corporates, there will naturally be a continued evolution and integration of the offerings of financing platforms. This is part of the current broader movement towards further embedded finance solutions, directly and seamlessly connecting origination, invoicing and payment systems within a corporate to an immediate funding source through the financing platform.

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SYNTHETIC SECURITISATION: COMPLETING THE EU REGULATORY PUZZLE

Contributors: Konstantinos Voulgarakis, Tim Cleary

One of the key regulatory reforms affecting synthetic securitisation in recent years was the introduction of the STS regime for on-balance-sheet (synthetic) securitisations in April 2021. However, when the regime was introduced, a number of elements of the framework were left to be supplemented through regulatory technical standards and guidelines, none of which have yet been finalised. This article provides a short update on these various initiatives.

Key Issues

- There have recently been a number of significant developments in the EU regulatory framework for synthetic securitisations, including:
  - The publication of the EBA final draft RTS on the determination of the exposure value of synthetic excess spread;
  - The impending implementation of the latest Basel accords;
  - The publication of the EBA final draft RTS on the homogeneity requirements; and
  - The EBA public consultation on proposed guidelines on the STS criteria.
- Certain elements included in the relevant final draft RTSs are expected to be welcomed by the industry including (a) the introduction of an exclusion of the 'SES for future periods' component from the calculation of the SES exposure value when certain conditions are met and (ii) grandfathering provisions in respect of existing transactions.
- The implementation of the latest Basel accords in EU legislation is also something that the industry awaits, in light of the current discussions in trilogue on whether the "p" factor should be divided by two for the purposes of the output floor calculation.

On 9 April 2021, as part of the EU Capital Markets Recovery Package, the simple, transparent and standardised ("**STS**") framework for securitisation in the EU was extended to apply to synthetic (i.e. on-balance-sheet) securitisations. The extension of the STS framework to synthetic securitisation was widely welcomed by the market, with the first transactions to adopt the label closing shortly after the regime came into effect. The regime has been particularly beneficial for banks operating under the Standardised Approach, as it reduces the "p" factor[49] used in the calculation of the risk-weights for the standardised approach by 50%. In addition, by reducing the risk-weight floor on the senior retained tranche from 15% to 10%, it has improved the efficiency of transactions for banks under both the Standardised Approach and the IRB Approach. Recent indications are that more than 50% of synthetic securitisations executed by EU banks now adopt the STS framework.

However, the framework is not yet complete. The level 1 text adding the framework into the EU Securitisation Regulation included a number of mandates for the European Banking Authority ("**EBA**"), including mandates to prepare guidelines on the harmonised interpretation and application of the simple, transparent and standardised ("**STS**") framework for on-balance-sheet ('synthetic') securitisations, and to prepare draft regulatory technical standards ("**RTS**") supplementing the framework.

Since the publication of 'Structured Debt in a New World' in March 2022[50], there have been a number of significant developments on the STS front, with the EBA launching a public consultation on proposed guidelines on the STS criteria for on-balance-sheet securitisations and publishing its final draft RTS on the homogeneity requirements for STS synthetic securitisations. Furthermore, the start of 2023 has also been eventful for the synthetic securitisation world more generally with the publication of the EBA's final draft RTS on the determination of the exposure value of synthetic excess spread and the impending implementation of the latest Basel accords in the EU legislative framework.

For the reasons set out below, the outcome of the EBA consultations and the publication of the relevant final draft RTSs are expected to be welcomed by the industry. Equally, the implementation of the latest Basel accords in EU legislation is also something that the industry awaits, in light of the current discussions in trilogue on whether the "p" factor should be divided by two for the purposes of the output floor calculation until a wider review of the securitisation framework as part of the Capital Markets Union Action Plan is undertaken.

49 The "p" factor is a non-neutrality factor used to deliberately increase the total capital charges associated with a securitised asset pool as compared to holding all the underlying assets directly on balance sheet. See further explanation below in the section "Basel IV, the output floor and the "p" factor".

50 https://www.cliffordchance.com/briefings/2022/03/structured-debt-in-a-new-world.html

EBA Final Report on Determining the Exposure Value for Synthetic Excess Spread

On 24 April 2023, the EBA published its final draft RTS specifying how the exposure value of synthetic excess spread ("**SES**") should be determined (the "**Final SES RTS**").[51] The proposed RTS are intended to give effect to the amendments that were made to Articles 248 and 256 of the CRR by Regulation (EU) 2021/558, which (a) established that SES must be considered a securitisation position by originator institutions, meaning that it must have an 'exposure value' and be risk-weighted in essentially the same way as a first loss tranche in the securitisation and (b) specified that the elements that should be included in the exposure value of the SES include (i) any SES recognised by the originator institution in its income statement that is still available to absorb losses, (ii) any SES in any previous periods that is still available to absorb losses, (iii) any SES for the current period that is still available to absorb losses, and (iv) any SES for future periods.

The Final SES RTS make two sets of proposals regarding how the exposure value of SES should be calculated. For SES that falls into categories (i) to (iii) above, the proposed RTS specify that the amount designated by the originator to absorb losses and that is still available for this purpose should be considered in full for the determination of the exposure value. This is largely unchanged from the approach that was proposed in the draft RTS[52] on which the EBA launched a public consultation on 9 August 2022 (the "**Consultation SES RTS**").

For SES falling into category (iv) above (i.e., for future periods), however, the EBA departed from its original proposal. In the Consultation SES RTS, the EBA had proposed two approaches which an originator could apply for this purpose (although it would have been required to apply the same approach for all securitisations: the Full Model Approach ("**FMA**") and the Simplified Model Approach ("**SMA**").

- Under the FMA, originators would have been required to determine the relevant losses expected to be covered by the SES for each period by comparing (i) the SES calculated for each of the future periods with (ii) the expected losses of each period. This determination was expected to be made under 3 scenarios (a front-loaded, an evenly-loaded and a back-loaded loss distribution scenario), with the sum of the losses expected to be covered by SES in these future periods constituting, in each scenario, the exposure value of SES for such future periods. Then, the arithmetic average of the exposure value of SES calculated under each of these three scenarios would constitute the SES for future periods on the relevant calculation date.
- Under the SMA, the exposure value would be calculated by multiplying the SES for the upcoming period by the weighted average life ("**WAL**") of the reference portfolio (as at the calculation date) and a scalar factor representing the capacity of the SES to absorb losses. The scalar factor was correspondingly conservative (either 0.8 or 1 depending on whether there is a "use-it-or-lose-it" ("**UIOLI**") mechanism). The EBA's expectation was that using the SMA would generally lead to a higher exposure value than the FMA.

The Consultation SES RTS attracted a large number of industry responses, many of which expressed concerns that the above approach would render the use of SES uneconomic for the originator in virtually all synthetic securitisations. As far as the proposed calculations methods were concerned, it was argued that requiring an originator to hold capital against what was effectively the lifetime expected losses (capped at the contractual amount of SES) is inconsistent with the principles underpinning the capital framework, which is based on a one-year time horizon. In addition, some of the responses expressed a preference for the status quo, i.e. the supervisory practices currently implemented by the European Central Bank, to be broadly maintained, while others highlighted the need for the regulatory framework for securitisation to adopt a consistent approach to traditional and synthetic securitisations.

Following consideration of the relevant feedback by the EBA, the Final SES RTS dropped the proposed FMA. The SMA was retained with a reduced scalar of 0.6 (rather than 0.8) for the UIOLI mechanism. The EBA noted in that regard that the SMA with the 0.6 scalar is understood to

51 EBA Final Report on Draft Regulatory Technical Standards specifying the determination by originator institutions of the exposure value of synthetic excess spread pursuant to Article 248(4) of Regulation (EU) No 575/2013, EBA/RTS/2023/02: https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2023/EBA-RTS-2023-02%20RTS%20on%20calculation%20of%20exposure%20value%20of%20SES/1054910/Draft%20RTS%20on%20the%20calculation%20of%20the%20exposure%20value%20of%20SES.pdf

52 Consultation Paper, Draft Regulatory Technical Standards, Specifying the determination by originator institutions of the exposure value of synthetic excess spread pursuant to Article 248(4) of Regulation (EU) No 575/2013, EBA/CP/2022/1: https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Consultations/2022/Consultation%20on%20draft%20RTS%20on%20the%20determination%20by%20originator%20institutions%20of%20the%20exposure%20value%20of%20SES%20in%20securitisations/1037741/CP%20on%20draft%20RTS%20on%20calculation%20of%20exposure%20value%20of%20SES.pdf

have considerably less negative impact on the activities of the EIF compared to the 0.8 scalar or compared to the FMA.

However, the two most important developments brought by the Final SES RTS are the introduction of (i) an exclusion of the 'SES for future periods' component from the calculation of the SES exposure value when certain conditions are met and (ii) grandfathering provisions in respect of existing transactions.

In particular, Article 6(2) of the Final SES RTS provides a derogation whereby the future component of the SES exposure value is set at zero for UIOLI SES if (a) the one-year SES amount is lower than or equal to the one-year expected loss amounts of the securitised exposures and (b) the credit protection agreement explicitly provides that the realised losses to be covered by the one-year SES amount do not exceed the realised net income of the securitised exposures. This second requirement is intended to produce an outcome which is broadly analogous to the use of excess spread in a traditional securitisation, where the income from the securitised exposures that is not used to cover the costs of the securitisation is available to absorb losses before any residual excess spread is paid through to the originator. In the context of a synthetic securitisation, because the securitised exposures remain on the balance sheet of the originator, the funding cost of those exposures is largely retained by the originator. For this reason, for the purpose of determining the net income of the securitised exposures, the originator is required to deduct from the income both the actual credit protection fees and other direct costs of the securitisation paid by the originator as well as a pro-rata share of the originator's costs and expenses (other than the credit protection fees and other direct costs of the securitisation) for the relevant year.

While this derogation is a very welcome development, it will require modification to existing practice for the use of SES, by requiring the introduction of an *ex-post* reconciliation to ensure that the amount of losses actually covered by SES for a given year did not exceed the net income for that year and, if it did, for the investors to cover those losses to the extent of the excess. It remains to be seen how such an adjustment mechanic will work in practice, or how it will change the way investors assess the inclusion of SES in transactions.

The introduction of grandfathering for synthetic securitisations originated prior to the entry into force of the RTS was a welcome, and largely unexpected, development in the Final SES RTS. Under Article 248(1)(b) of the CRR, the RTS were supposed to have been submitted to the Commission by 10 October 2021, in order to provide time for them to enter into force before the requirement to calculate the exposure value of SES came into effect on 10 April 2022. In the absence of the RTS, there has therefore been considerable uncertainty since 10 April 2022 as to exactly how originators are supposed to comply with the requirements of Article 248(1)(a) of the CRR. As the principal supervisor in the EU, the ECB has continued to apply its pre-existing practice of requiring originators to hold capital against a one-year rolling amount of SES. The Final SES RTS effectively endorse that approach by permitting the originators of existing securitisations to continue applying whatever method they have been applying to date in accordance with applicable supervisory practices until the maturity of that securitisation.

Notwithstanding some residual concerns from originators about the method of calculating the net income of the securitisation for the purpose of excluding the value of SES for future periods, it is expected that the industry will generally welcome the EBA's revised proposals, which largely addressed the concerns raised during the consultation process. The final draft RTS will be submitted to the Commission for endorsement and will then be published in the Official Journal of the European Union.

Basel IV, the Output Floor and the "p" Factor

Through a series of amendments between December 2017 and 2019, the Basel Committee on Banking Supervision finalised the third instalment of the Basel accords (also known as Basel 3.1 or "**Basel IV**") creating a regulatory framework for bank capital adequacy, stress testing and market liquidity risk. One of the key objectives of the Basel IV reforms was the reduction of excessive variability in the calculation of risk-weighted assets ("**RWAs**") between banks using the standardised approach and banks using internal models and an improvement in transparency and comparability of different banks' capital calculations and ratios.

To that end, one of the amendments to the Basel III framework was the addition of the "output floor" (the "**SA Output Floor**"), which was created to address modelling risk for internal calculations (for securitisations, this is the SEC-IRBA approach). In particular, the SA Output Floor sets a limit on the amount by which a bank's internal models can reduce its overall capital requirement for credit risk compared with the requirement that would apply under the Standardised Approach. This will work by providing that, in aggregate, SEC-IRBA-generated RWAs cannot fall below 72.5% of the equivalent RWAs computed under the standardised approaches. This is being phased in over a 6-year implementation phase (known-as "phase-in" for the SA Output Floor) during

which the minimum SEC-IRBA-generated RWAs will slowly rise from 50% to 72.5% of equivalent standardised RWAs.

Both the EU and the UK have initiated the relevant legislative and regulatory processes to implement the Basel IV framework. On 27 October 2021, the European Commission published proposed amendments to the CRR which, *inter alia*, introduce the SA Output Floor into EU law (referred to as "**CRR3**"). The proposed amendments under CRR3 are currently at the 'trilogue' stage, with both the Council and the European Parliament already having published their positions on 31 October 2022[53] and 9 February 2023[54] respectively. Latest discussions as April 2023 appear to still include the SA Output Floor as a point of friction in the negotiations. In the UK, the Financial Services Act 2021 grants HM Treasury the power to make consequential provisions or other regulations to incorporate Basel IV into the UK's prudential framework and to delegate legislative powers, as appropriate, to the Prudential Regulation Authority ("**PRA**") (and the Financial Conduct Authority). To that end, HM Treasury and the PRA each launched a consultation on 30 November 2022 in respect of the implementation of Basel IV.[55] The PRA's consultation includes the substantive text of the amendments and, as expected, maintains a position of "super-equivalence" with the Basel standards.

The SA Output Floor has a particularly significant impact on a SRT securitisation, in a way which does not appear to have featured in the formulation of the floor. This impact results from the effect of tranching. In order to achieve significant risk transfer, an originator is required to transfer, at a minimum, a certain amount of capital requirements associated with the securitised portfolio. A further key input into each of the SEC-IRBA and SEC-SA formulae used to calculate the risk-weight for each retained tranche in the securitisation is the pre-securitisation capital charge of the securitised portfolio. As a general rule, the unsecuritised capital charge for a portfolio will be significantly higher under the Standardised Approach than it would be under the IRB Approach. It follows from this that, in order to minimise the risk-weight for the retained senior tranche of a SRT securitisation, the amount of risk to be transferred (ie, the thickness of the first loss or mezzanine tranche(s) placed with investors) will need to be much greater when applying the SEC-SA than it will be under the SEC-IRBA. Indeed, the difference is so significant that when a portfolio is tranched under the SEC-IRBA, a placed tranche of 8% will usually be sufficient to generate a senior tranche risk-weight of 15% or 10% (the risk-weight floor for non-STS and STS securitisations, respectively). However, an 8% tranche would likely result in a senior tranche risk-weight under the SEC-SA in excess of 70%, which is clearly uneconomic. The only way of avoiding this outcome is to place much thicker tranche(s) with investors, which significantly increases the cost of the securitisation, or by otherwise modifying the SEC-SA formula to reduce the differential between the risk-weights generated by the SEC-IRBA and the SEC-SA for the same tranching.

The imposition of the SA Output Floor has been the subject of extensive criticism within the securitisation industry[56]. In addition, its pending implementation has re-energised the industry's calls for a recalibration of the SEC-SA by lowering the "p" factor. The "p" factor is a non-neutrality correction factor included in both the SEC-IRBA and the SEC-SA, which aims to capture the agency and model risks prevalent in securitisations. Under SEC-SA, there is a fixed "p" factor of 1 (for non-STS securitisations) and 0.5 (for STS securitisations). Under the SEC-IRBA, banks may calculate their own supervisory parameter based on four risk factors, i.e., the framework (correlation effect), the granularity of the securitised pool for wholesale, the capital charge for the underlying exposures, the average loss given default of the securitised pool, plus one non-risk parameter (tranche maturity M_T, capped at 5 years), which is subject to a floor of 0.30.

In practice, the "p" factor imposes a premium capital charge on all

53 General approach on regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor, 2021/0342 (COD): https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CONSIL:ST_13772_2022_INIT

54 Report on the proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor, A9-0030/2023: https://www.europarl.europa.eu/doceo/document/A-9-2023-0030_EN.pdf

55 HM Treasury, Implementation of the Basel 3.1 Standards, Consultation (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1120898/HMT_Basel_3.1__consultation_document.pdf) and PRA CP 16/22 (https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standardswhich), which closed in end March.

56 In its Research Report entitled "Impact of the SA Output Floor on the European Securitisation Market" and dated 11 November 2022, the Association for Financial Markets in Europe concluded that, if the Output Floor is implemented as currently envisaged, it would significantly disfavour corporate securitisations, both for large corporates and SME portfolios, and it would likely result in existing SRT transactions failing the Significant Risk Transfer (SRT) test applied by EU supervisors: https://www.afme.eu/Portals/0/DispatchFeaturedImages/Impact%20of%20the%20SA%20Floor%20on%20European%20Securitisation%2022-65a%2014-6-22%20v68.pdf

securitisations (regardless of seniority, maturity, or any other credit enhancing features of the transaction), and hence, has been questioned by market participants. The industry has argued that there are already alternative correction factors which impose an implicit premium on securitisations, including capital floors. The introduction of yet another correction factor in the form of the SA Output Floor therefore makes the industry's requests to lower the "p" factor topical once again.

A proposal to reduce the "p" factor was recently considered by the Joint Committee of the European Supervisory Authorities (EBA, EIOPA and ESMA) ("**ESAs**") (as to which see the article entitled "*ESAs Joint Advice: a false dawn for the European securitisation prudential framework?*" earlier in this volume) in the context of their response to the European Commission's October 2021 call for advice on the review of the securitisation prudential framework. In their banking-specific advice dated 12 December 2022,[57] rather than reducing the "p" factor, the ESAs recommended a reduction in the risk weight floor applicable to senior tranches retained by originators instead. In particular, the EBA considered that this would be a more impactful measure than a reduction of the "p" factor, which it believes increases cliff effects (i.e. the "p" factor incorporates the capital non-neutrality but also serves as a smoothing parameter to avoid cliff effects). This would not, however, address the issue caused by the SA Output Floor because, for the reasons summarised above, when the SEC-SA formula is applied, the risk-weight of the retained senior tranche would significantly increase, to be well above the floor anyway.

In light of the above, the publication of the European Parliament ECON Committee's Report dated 9 February 2023 in respect of the Commission's CRR3 proposal was a surprising development. That is because the report introduces a transitional provision[58] whereby the "p" factor under the SEC-SA should be reduced by 50% for the purposes of the SA Output Floor calculation until a wider review of the securitisation framework as part of the Capital Markets Union Action Plan is undertaken. Following publication of the European Parliament report, there have also been indications that the EU Commission would consider not only halving the "p" factor under the SEC-SA per the above, but also making the "p" factor under the SEC-IRBA subject to a floor of 0.1 (down from 0.3 currently), and subject to a cap of 0.3. At the time of writing, the political negotiations on CRR3 are incomplete, making it uncertain whether this amendment will make it into the final CRR3 text and, if so, in what form.

There is currently no proposal from the PRA to make a similar adjustment to the "p" factor in connection with the UK implementation of Basel IV, although the PRA has acknowledged the industry concerns and that they are intending to discuss its implications with affected industry participants.

EBA Final Report on Draft RTS on Homogeneity of Underlying Exposures in STS Securitisations

On 14 February 2023, the EBA published its final report (the "**Homogeneity Final Report**")[59] on draft RTS specifying the criteria for the underlying exposures in securitisation transactions to be deemed homogeneous. The relevant mandate was part of the introduction of a cross-sectoral framework for STS on-balance-sheet synthetic securitisations (see Article 26b(13) of the Securitisation Regulation).

For the purposes of developing the draft RTS, the EBA launched a public consultation on 28 July 2022[60] where it considered a few options, including (i) to extend the scope of Delegated Regulation (EU) 2019/1851 on homogeneity of the underlying exposures for traditional securitisations (the "**Existing Homogeneity RTS**") to on-balance-sheet securitisations with certain amendments or (ii) to develop a new separate RTS for STS on-balance-sheet securitisations, and opted for the former.

Two items stood out from the EBA's proposals and attracted considerable market feedback. The first one was the

57 Joint Committee Advice on the review of the securitisation prudential framework (Banking), JC/2022/66: https://www.eiopa.europa.eu/system/files/2022-12/jc_2022_66_-_jc_advice_on_the_review_of_the_securitisation_prudential_framework_-_banking.pdf

58 See the proposed amendments to Article 465 of the Commission's CRR3 proposal.

59 Final Report, Draft Regulatory Technical Standards on the homogeneity of the underlying exposures in STS securitisation under Articles 20(14), 24(21) and 26b(13) of Regulation (EU) 2017/2402, as amended by Regulation (EU) 2021/557, EBA/RTS/2023/01: https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2023/EBA-RTS-2023-01%20RTS%20on%20homogeneity/1051902/Final%20draft%20Regulatory%20Technical%20Standards%20on%20the%20homogeneity%20of%20the%20underlying%20exposures%20in%20STS%20securitisation.pdf

60 Consultation Paper, Draft Regulatory Technical Standards on the homogeneity of the underlying exposures in STS securitisation under Articles 20(14), 24(21) and 26b(13) of Regulation (EU) 2017/2402, as amended by Regulation (EU) 2021/557, EBA/CP/2022/09: https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Consultations/2022/Consultation%20paper%20on%20draft%20RTS%20on%20the%20homogeneity%20of%20the%20underlying%20exposures%20in%20STS%20securitisation/1037481/Consultation%20Paper%20on%20the%20draft%20RTS%20on%20homogeneity.pdf

proposal that a separate type of obligor for exposures to large corporates should be introduced making it difficult to obtain an STS designation for a portfolio containing large corporate exposures along with other corporate exposures. The term "large corporate" was to have the meaning given to it in Article 142(1) point (5a) of the Commission's CRR3 proposal, i.e. "any corporate undertaking having consolidated annual sales of more than EUR 500 million or belonging to a group where the total annual sales for the consolidated group is more than EUR 500 million". The second one was the proposal that on-balance-sheet synthetic securitisations which were deemed homogeneous before the entry into force of the amending RTS should fall within the scope of application of the amending RTS one year after its entry into force.

For the first item, respondents highlighted, among other things, the difficulties of securitising exposures on the basis of the proposed definition, and the impact on sufficient portfolio granularity given that the definition does not align with how most banks distinguish exposures for the purposes of their origination and underwriting standards. As a result, the EBA decided to abandon the proposal and recommended that the distinction in the Existing Homogeneity RTS, which differentiates between SME and non-SME corporate obligors, should be maintained. In addition, and similar to the approach followed in the Existing Homogeneity RTS, no definition of SMEs has been introduced and it is expected that the assignment of a particular exposure to a category will be based on the internal classification of the originator.

For the second item, respondents pointed out that the lack of grandfathering provisions for on-balance-sheet STS securitisations would have a significant impact on the market, as it would result in a large number of transactions losing their STS classification due to the inability to amend existing transactions to meet the new requirements. Following this feedback, the EBA now proposes in its Final Report that grandfathering provisions should also be included for STS on-balance-sheet securitisations which were notified to ESMA prior to the entry into force of the RTS.

While there had been some hope that the EBA might include some additional homogeneity classifications for certain types of corporate exposures, the industry will likely welcome the EBA's decision to retain the *status quo*, which has been working reasonably well for on-balance-sheet STS securitisations since April 2021.

The rest of the changes that were the subject of the EBA's public consultation remained intact. In summary, the substantive proposals in the Homogeneity Final Report comprise:

- An extension of the scope of application of the Existing Homogeneity RTS to on-balance-sheet synthetic securitisations entered into after the entry into force of the amending RTS.
- A clarification in respect of (i) the auto loans and leases asset type and (ii) the credit card receivables asset type that, where the relevant homogeneity factor is the "type of obligor" category of individuals, this should also include those enterprises where the originator applies the same credit risk assessment approach as for exposures to individuals.
- An amendment to the "credit facilities provided to individuals for personal, family or household consumption purposes" asset type to also include credit facilities provided to enterprises where the originator applies the same credit risk assessment approach as for individuals.

The final draft RTS will be submitted to the Commission for adoption (with or without amendment) and will then be published in the Official Journal of the European Union.

EBA Consultation on STS Guidelines

On 21 April 2023, the EBA launched a public consultation on its draft guidelines on the STS criteria for on-balance-sheet securitisation[61] ("**Synthetic STS Guidelines**"). In line with the EBA Guidelines published in December 2018 in connection with non-ABCP[62] and ABCP securitisations[63], the proposed Synthetic STS Guidelines aim to provide a single point of consistent and correct implementation of the STS criteria for synthetic securitisations.

Therefore, for the STS requirements that are similar across synthetic and non-ABCP securitisations, the Synthetic STS

61 Consultation Paper on draft Guidelines on the STS criteria for on-balance-sheet securitisations, EBA/CP/2023/09: https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Consultations/2023/Consultation%20on%20draft%20Guidelines%20on%20the%20STS%20criteria%20for%20on-balance-sheet%20securitisations/1054818/CP%20on%20draft%20Guidelines%20on%20the%20STS%20criteria%20for%20on-balance-sheet%20securitisations.pdf

62 Final Report on Guidelines on the STS criteria for non-ABCP securitisation, EBA/GL/2018/09: https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2519490/feb843e1-9b01-420a-a956-332bfc513922/Guidelines%20on%20STS%20criteria%20for%20non-ABCP%20securitisation.pdf?retry=1

63 Final Report on Guidelines on the STS criteria for ABCP securitisation, EBA/GL/2018/08: https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2519490/4d16ee5b-2ef9-4f8c-9c75-f0e5e84da674/Guidelines%20on%20STS%20criteria%20for%20ABCP%20securitisation%29.pdf

Guidelines are identical to the interpretation provided in the EBA Guidelines on non-ABCP securitisations. The EBA has helpfully also included a comparison section, explaining in each instance whether the interpretation is aligned between the two types of securitisations or not.

There are also instances, however, where (a) while the requirements are common, specificities of on-balance-sheet securitisations require the interpretation to be adapted or (b) the requirements are specific to synthetic securitisations and there are no equivalent requirements for non-ABCP securitisations.

The first category includes, for example, requirements regarding the amortisation of tranches set out in Article 26c(5) of the Securitisation Regulation. In particular, the guidance in the Guidelines on non-ABCP securitisation is focused on interpreting the term “performance-related triggers”, which, for STS on-balance-sheet securitisations, has in the meantime been clarified in the RTS on performance related triggers. In addition, the Synthetic STS Guidelines provide further clarification of the terms “reversion to non-sequential amortisation”, “significant losses”, “last part of the maturity of the transaction”, and “back-loaded loss distribution scenario”, as a follow up to the requirements specified in the meantime in the RTS on performance-related triggers.

The second category includes, among others, requirements in relation to the recourse to high-quality collateral (Article 26e(10)), synthetic excess spread (Article 26e(7)), early termination events exercisable by the investor (Article 26e(6)) or the originator (Article 26e(5)) or the verification agent (Article 26e(4)) and in respect of which, in some instances, the EBA considers the level 1 text sufficiently clear and does not provide any further interpretation and, in other instances, where additional guidance is provided.

The consultation will be open until 7 July 2023. Following their finalisation, the guidelines will be translated into the official EU languages and published on the EBA website.

CONTACTS

London

Simi Arora-Lalani
Partner
T: +44 20 7006 8282
E: simi.arora-lalani@
cliffordchance.com

Timothy Cleary
Partner
T: +44 20 7006 1449
E: timothy.cleary@
cliffordchance.com

Adam Craig
Partner
T: +44 20 7006 8862
E: adam.craig@
cliffordchance.com

Kevin Ingram
Partner
T: +44 20 7006 2416
E: kevin.ingram@
cliffordchance.com

Bruce Kahl
Partner
T: +44 20 7006 2419
E: bruce.kahl@
cliffordchance.com

Louise Keary
Partner
T: +44 20 7006 1249
E: louise.keary@
cliffordchance.com

Jessica Littlewood
Partner
T: +44 20 7006 2692
E: jessica.littlewood@
cliffordchance.com

Emma Matebalavu
Global Head of Global Financial Markets
T: +44 20 7006 4828
E: emma.matebalavu@
cliffordchance.com

Simeon Radcliff
Partner
T: +44 20 7006 2786
E: simeon.radcliff@
cliffordchance.com

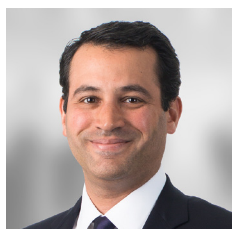
William Sutton
Partner
T: +44 20 7006 3400
E: william.sutton@
cliffordchance.com

Julia Tsybina
Partner
T: +44 20 7006 4368
E: julia.tsybina@
cliffordchance.com

Christopher Walsh
Partner
T: +44 20 7006 2811
E: christopher.walsh@
cliffordchance.com

Maggie Zhao
Partner
T: +44 20 7006 2939
E: maggie.zhao@
cliffordchance.com

Global



Lee Askenazi
Partner
New York
T: +1 212 878 8230
E: lee.askenazi@
cliffordchance.com

Daniel Badea
Managing Partner
Bucharest
T: +40 216666 101
E: daniel.badea@
cliffordchance.com

Chad Bochan
Partner
Sydney
T: +61 2 8922 8501
E: chad.bochan@
cliffordchance.com

Jim Cotins
Partner
New York
T: +1 212 878 4944
E: james.cotins@
cliffordchance.com

José Manuel Cuenca
Partner
Madrid
T: +34 91590 7535
E: josemanuel.cuenca@
cliffordchance.com

Lounia Czupper
Partner
Brussels
T: +32 2 533 5987
E: lounia.czupper@
cliffordchance.com

Alistair Dunlop
Partner
New York
T: +1 212 878 3259
E: alistair.dunlop@
cliffordchance.com

Francis Edwards
Partner
Hong Kong
T: +852 2826 3453
E: francis.edwards@
cliffordchance.com

Mariana Estévez
Partner
New York
T: +1 212 878 8251
E: mariana.estevez@
cliffordchance.com

Eduardo García
Partner
Madrid
T: +34 91 590 9411
E: eduardo.garcia@
cliffordchance.com

Steve Jacoby
Partner
Luxembourg
T: +352 48 5050 219
E: steve.jacoby@
cliffordchance.com

Oliver Kronat
Partner
Frankfurt
T: +49 69 7199 4575
E: oliver.kronat@
cliffordchance.com

Frédérick Lacroix
Partner
Paris
T: +33 1 4405 5241
E: frederick.lacroix@
cliffordchance.com

Leng-Fong Lai
Co-Managing Partner
Tokyo
T: +81 3 6632 6625
E: leng-fong.lai@
cliffordchance.com

Paul Landless
Partner
Singapore
T: +65 6410 2235
E: paul.landless@
cliffordchance.com

Global

Jonathan Lewis
Partner
Paris
T: +33 1 4405 5281
E: jonathan.lewis@
cliffordchance.com

Matt Lyons
Partner
New York
T: +1 212 878 4922
E: matthew.lyons@
cliffordchance.com

Marc Mehlen
Partner
Luxembourg
T: +352 48 50 50 305
E: marc.mehlen@
cliffordchance.com

Grzegorz Namiotkiewicz
Partner/Advocate
Warsaw
T: +48 22429 9408
E: grzegorz.namiotkiewicz@
cliffordchance.com

Rebecca O'Brien
Partner
New York
T: +1 212 878 8263
E: rebecca.obrien@
cliffordchance.com

Gareth Old
Partner
New York
T: +1 212 878 8539
E: gareth.old@
cliffordchance.com

Julien Rocherieux
Partner
Paris
T: +33 1 4405 5952
E: julien.rocherieux@
cliffordchance.com

Tanja Svetina
Partner
Milan
T: +39 02 8063 4375
E: tanja.svetina@
cliffordchance.com

Stuart Ure
Partner
Dubai
T: +971 4503 2659
E: stuart.ure@
cliffordchance.com

Nienke van Stekelenburgh
Partner
Amsterdam
T: +31 20 711 9654
E: nienke.vanstekelenburgh@
cliffordchance.com

Robert Villani
Partner
New York
T: +1 212 878 8214
E: robert.villani@
cliffordchance.com

Jonathan Zonis
Partner
New York
T: +1 212 878 3250
E: jonathan.zonis@
cliffordchance.com

Other contributors

Chris Bates
Consultant
T: +44 20 7006 1041
E: chris.bates@cliffordchance.com

Andrew E. Bryan
Knowledge Director
London
T: +44 20 7006 2829
E: andrew.bryan@cliffordchance.com

Maddie Burrell
Lawyer
London
T: +44 20 7006 1920
E: maddie.burrell@cliffordchance.com

Soojean Choi
Senior Associate
London
T: +44 20 7006 1075
E: soojean.choi@cliffordchance.com

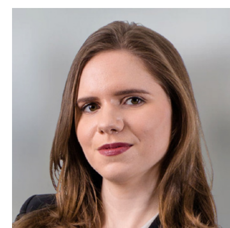
Simon Connor
Senior Associate
London
T: +44 20 7006 5304
E: simon.connor@cliffordchance.com

Caroline Dawson
Partner
T: +44 20 7006 4355
E: caroline.dawson@cliffordchance.com

Paul Deakins
Partner
T: +44 20 7006 2099
E: paul.deakins@cliffordchance.com

Laura Douglas
Senior Associate
London
T: +44 20 7006 1113
E: laura.douglas@cliffordchance.com

Emma Eaton
Senior Associate
London
T: +44 20 7006 1789
E: emma.eaton@cliffordchance.com



Jacklyn Hoffman
Associate
New York
T: +1 212 878 8058
E: jacklyn.hoffman@cliffordchance.com

Precious Ivongbe
Lawyer
London
T: +44 20 7006 3894
E: precious.ivongbe@cliffordchance.com

Mikhail Kleptsov
Senior Associate
London
T: +44 20 7006 1959
E: mikhail.kleptsov@cliffordchance.com

Shadi Langeroodi
Senior Associate
Knowledge Lawyer
London
T: +44 20 7006 8890
E: shadi.langeroodi@cliffordchance.com

Paul Lenihan
Senior Associate
London
T: +44 20 7006 4622
E: paul.lenihan@cliffordchance.com

Julia Machin
Knowledge Director
London
T: +44 20 7006 2370
E: julia.machin@cliffordchance.com

Other contributors

Alberto Maero
Senior Associate
Milan
T: +39 02 8063 4244
E: alberto.maero@cliffordchance.com

Anna-Lena Marx
Lawyer
London
T: +44 20 7006 5542
E: annalena.marx@cliffordchance.com

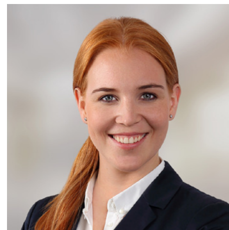
Mark McGuire
Senior Associate
London
T: +44 20 7006 3603
E: mark.mcguire@cliffordchance.com

Stephanie Peacock
Senior Associate
London
T: +44 20 7006 4387
E: stephanie.peacock@cliffordchance.com

Jesus Quesada
Counsel
Madrid
T: +34 91 590 4174
E: jesus.quesada@cliffordchance.com

Konstantinos Voulgarakis
Senior Associate
London
T: +44 20 7006 4671
E: konstantinos.voulgarakis@cliffordchance.com

Jessica Walker
Knowledge Director
London
T: +44 20 7006 2880
E: jessica.walker@cliffordchance.com



Antonia Walter
Senior Associate
London
T: +49 69 7199 1323
E: antonia.walter@cliffordchance.com

James Watkins
Senior Associate
London
T: +44 20 7006 4576
E: james.watkins@cliffordchance.com

Cheng Li Yow
Partner
London
T: +44 20 7006 8940
E: chengli.yow@cliffordchance.com

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