Securitisation Update – Recent Amendments and Guidance

In recent weeks there have been several updates and amendments at EU level in relation to Regulation (EU) 2017/2402 (the "**Securitisation Regulation**") that will be of particular interest to participants in the securitisation market. In this article we summarise the key take away points with respect to:

1. amendments to the Securitisation Regulation (and Regulation (EU) 575/2013 (the "**Capital Requirements Regulation**" or "**CRR**")) effective from 9 April 2021; and
2. publications from the European Supervisory Authorities ("**ESAs**")[1] on 26 March 2021 comprising:
   a. an opinion to the European Commission on the jurisdictional scope of application of the Securitisation Regulation; and
   b. Q&As on cross-sectoral aspects of the Securitisation Regulation.

1. Amendments to the Securitisation Regulation

On 6 April 2021 final texts for amending regulations to (i) the Securitisation Regulation and (ii) the CRR (collectively, the "**Amendments**") were published in the Official Journal of the EU. For the most part the Amendments take effect from 9 April 2021 (save for certain provisions relating to STS securitisations under the CRR (as further described below) which are not effective until 10 April 2022).

As a precursor to the Amendments, the European Parliament acknowledged, in its adopted texts published on 29 March 2021, that the capacity of financial institutions in the EU to provide liquidity would be essential to fund economic recovery in the aftermath of the COVID-19 pandemic (whilst ensuring that such organisations act in a prudent manner) . Furthermore, in the recitals to the Amendments to the CRR, the European Parliament and European Council specifically focused on a functioning securitisation framework as being central to such recovery by stating that "*Securitisation is an important element of well-functioning financial markets since it contributes to diversifying the funding sources of institutions and releasing regulatory capital that can be reallocated to support further lending*".

Securitisation Regulation Amendments

- **Article 4 Prohibited jurisdictions for SSPEs**: Securitisation special purpose entities ("**SSPEs**") should only be established in third countries that are not listed on the EU list of non-cooperative jurisdictions for tax purposes or in the list of high risk third countries which have strategic deficiencies in their regimes on anti-money laundering and counter terrorist financing in accordance with Article 9 of Directive (EU) 2015/849.
- **Article 6 Risk Retention for NPE Portfolios**: As SSPEs purchase Non-Performing Exposures ("**NPEs**") at a discount to their nominal value and investor risk is benchmarked to the discounted value, the Amendments provide that risk retention shall be calculated by reference to the sale price of a portfolio of NPEs rather than to its nominal value.

1 The ESAs are comprised of the European Banking Authority ("**EBA**"), the European Insurance and Occupational Pensions Authority ("**EIOPA**") and the European Securities and Markets Authority ("**ESMA**"). The purpose of the ESAs is to foster common supervisory approaches and cross-sectoral consistency in the interpretation and application of EU regulation.

- **Article 5(1) Credit Granting Standards for NPE Portfolios**: For NPE securitisations, confirmation that sound credit granting standards were adhered to at origination is somewhat irrelevant for an investor's due diligence process as such exposures have since failed to perform as anticipated. The Amendments therefore instead require sound standards with respect to the selection and pricing of exposures which comprise NPE portfolios.
- **Article 26 STS Eligibility for Synthetic Securitisations**: Synthetic securitisations involve a transfer of credit risk of loans pursuant to a credit derivative instrument or financial guarantee rather than by a true sale of assets to an SSPE. The Amendments pave the way for synthetic securitisations to become eligible to qualify as simple, transparent and standardised or "**STS**" securitisations and thereby benefit from the favourable regulatory treatment that such transactions attract. Article 26 sets out detailed provisions specific to the on-balance sheet nature of synthetic securitisations, including requirements as to standardisation, transparency obligations and specific criteria to be contemplated in a synthetic STS securitisation.
- **Article 45 Development of a sustainable securitisation framework**: Article 45 has the overarching aim of integrating Regulation (EU) 2019/2088 on sustainability-related disclosures ("**SFDR**") with the Securitisation Regulation and introducing a framework for disclosure and due diligence requirements with respect to the underlying securitised exposures. Specifically, Article 45 states that "*By 1 November 2021, EBA, in close cooperation with ESMA and EIOPA, shall publish a report on developing a specific sustainable securitisation framework for the purpose of integrating sustainability-related transparency requirements into this Regulation*".

CRR Amendments

As discussed in our previous publication "European Commission Action Plan for NPLs" there is an expectation at EU level that the market for NPEs will increase as a result of the economic effects of the COVID-19 pandemic. As discussed in that publication, one possible barrier to entrants into the buy side of the NPE market is the manner in which risk weighting under CRR for NPEs is determined. The Amendments to the CRR clearly acknowledge this by including new provisions which clarify how risk weighting with respect to a securitisation of NPEs should be calculated.

In addition, certain changes to the CRR have been introduced to address the determination of the risk weighting associated with synthetic STS securitisations. However, the revised CRR only extends STS eligibility to retained senior tranches, which is a narrower focus than STS treatment for traditional securitisations. Provisions have been included in the CRR to deal with "synthetic excess spread" under such synthetic STS securitisations, however such sections shall not take effect until 10 April 2022 pending the development of associated regulatory technical standards.

2. ESAs publications on Securitisation Regulation

(a) Opinion to the European Commission on the jurisdictional scope of application of the Securitisation Regulation

The ESAs published a joint opinion on the jurisdictional scope of the Securitisation Regulation (the "**Opinion**"). Since its coming into force, there has been some confusion about whether, and to what extent, the Securitisation Regulation imposes obligations on third country entities participating in European securitisations. This question has, of course, become all the more important with the end of the Brexit transition period on 31 December 2020.

The Opinion sets out the views of the ESAs on certain aspects of the jurisdictional question, and calls on the European Commission to issue interpretive guidance. It begins by noting that the Securitisation Regulation does not prohibit entities located in third countries from being party to a securitisation, but that the participation of such third country entities in EU securitisations gives rise to certain difficulties in interpreting the obligations set out in Articles 5 to 7 and Article 9.

The Opinion then discusses various aspects of the Securitisation Regulation which are particularly impacted by questions of jurisdictional scope. Some of the key observations made by the ESAs in the Opinion are set out below.

- **Securitisations where all sell-side entities are outside the EU**: Where none of the "sell-side entities" (the originator, sponsor, original lender and securitisation special purpose entity ("**SSPE**")) are located in the EU, the securitisation is not directly subject to the requirements set out in Articles 6, 7 and 9; however, the securitisation may still need to comply with those requirements in practice, as institutional investors who are within the scope of Article 5 will, by virtue of their due diligence obligations as set out in that provision, need to satisfy themselves that those requirements are complied with before investing.

- **Securitisations where some sell-side entities are outside the EU**: Where some, but not all, of the sell-side entities are located in the EU, the ESAs note that there are two potential interpretations available:

  - Option 1 is to treat the securitisation as not being directly subject to the requirements of Articles 6, 7 and 9 (but the securitisation would still be indirectly subject to those requirements by virtue of Article 5, as described above).

  - Option 2 is to treat the EU-based sell-side entities as being directly responsible for fulfilling the requirements set out in Articles 6, 7 and 9.

  Of these two options, the ESAs prefer option 2, as they argue it would make it easier for the ESAs and competent authorities to effectively supervise compliance with Articles 6, 7 and 9. The Opinion also suggests that, in the event that the European Commission determines that option 2 is not a feasible interpretation of the Securitisation Regulation, the Commission should consider amending the Securitisation Regulation to allow for the option 2 approach as part of the upcoming review of the Securitisation Regulation.

- **EU institutional investors and third country securitisations**: The ESAs are of the view that the due diligence obligations set out in Article 5 may be understood as applying to institutional investors even where they invest in third country securitisations. Such an approach could make it very difficult for institutional investors based in the EU to invest in third country securitisations, as it is unlikely that such securitisations would be structured to comply with all of the relevant requirements imposed by the Securitisation Regulation, in particular the transparency requirements under Article 7. In light of the difficulties that this could pose for institutional investors, the ESAs are of the view that Article 5(1)(e) may be overly inflexible and call upon the European Commission to assess the feasibility of incorporating a third country equivalence regime for transparency requirements.

- **Third country subsidiaries of EU institutional investors**: The ESAs note that third country subsidiaries of EU institutional investors (who are indirectly subject to Article 5 of the Securitisation Regulation by virtue of Article 14 CRR) face similar difficulties as set out above with respect to third country securitisations, but that these difficulties may be compounded as a result of such subsidiaries' weaker links with the EU, and that this may place those subsidiaries at a competitive disadvantage vis-à-vis local investors.

  The ESAs therefore suggest that Article 14 CRR be amended to permit EU institutional investors to ring-fence third country subsidiaries investing in securitisations from the EU group, as an alternative to ensuring that such subsidiaries comply with Article 5. Where such ring-fencing is itself not feasible, the ESAs suggest that, as a further alternative, competent authorities should be able to impose proportionate investment limits on the subsidiary's investment in third country securitisations.

- **Third country and sub-threshold AIFMs**: The ESAs note that there is some confusion as to whether the definition of "*institutional investor*" in the Securitisation Regulation includes alternative investment funds managers ("**AIFMs**") based outside the EU. A literal interpretation of the definition would suggest that third country AIFMs that manage and / or market one or more AIFs in the EU are within the scope of the definition (and therefore subject to Article 5), even where cross-border marketing activity within the EU is limited. The ESAs suggest that the Securitisation Regulation and Alternative Investment Fund Managers Directive ("**AIFMD**") be amended to clarify that third country AIFMs will be subject to the due diligence obligations set out in Article

  17 of AIFMD and Article 5 of the Securitisation Regulation with respect to those AIFs that they manage and / or market in the EU. The ESAs also suggest that the relevant legislation should be amended to clarify which competent authority is responsible (and empowered) to supervise and enforce the requirements of Article 5 in respect of third country AIFMs.

  The ESAs also call on the European Commission to clarify, by way of an amendment to the definition of "*institutional investor*", whether those AIFMs which fall below the thresholds set out in Article 3(2) of AIFMD should be subject to the obligations in Article 5.

  Finally, the ESAs also call for more clarity around the circumstances in which institutional institutions and sponsors may delegate their Securitisation Regulation obligations to third country AIFMs.

(b) Q&As on cross-sectoral aspects of the Securitisation Regulation

The ESAs also published a questions and answers document on cross-sectoral aspects of the Securitisation Regulation (the "**Q&As**"). The Q&As are intended to address questions relating to the Securitisation Regulation which fall outside the exclusive competence of the EBA, ESMA or EIOPA. Although the Q&As are short, they address important questions of relevance to market participants. Some of the key insights from the Q&As are summarised below.

- **Summary of underlying documentation**: Article 7(a)(b) obliges the originator, sponsor and SSPE of a securitisation to make available "*all underlying documentation that is essential for the understanding of the transaction*". Article 7(1) goes on to say that "*the originator, sponsor and SSPE may provide a summary of the documentation concerned*".

  The ESAs have clarified that this language does not mean that originators, sponsors and SSPEs may choose whether to make available full documentation or a summary thereof. Rather – reading the provision in context – the option to provide a summary of the underlying documentation is available only where disclosure of the full documentation would result in a breach of national and EU confidentiality and data protection law.

- **Level of completeness of pre-pricing information**: Article 7(1) requires certain documents – including, among other things, the "*final offering document*" and "*closing transaction documents*" – to be made available before pricing. There had initially been some confusion in the market as to how to comply with this obligation given that, in typical securitisation transactions, the offering documents and transaction documents can only be fully finalised after pricing has occurred. The ESAs have clarified that information that is to be made available before pricing must be "*at least in draft or initial form*". This clarification is in line with the approach that has been taken in the market since entry into force of the Securitisation Regulation.

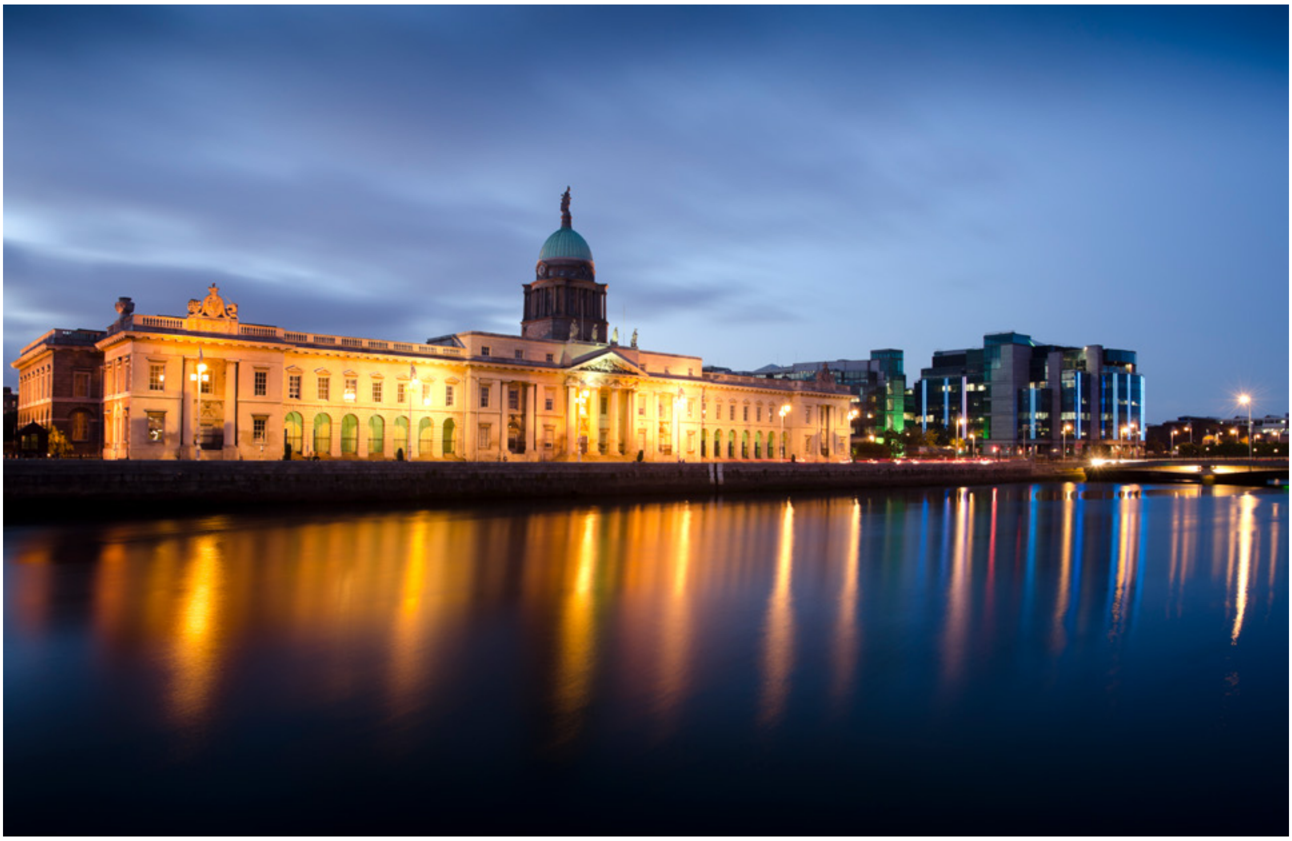
  The ESAs have further clarified that they expect that only minor changes should be made to such information post-pricing. In particular, financial variables (eg, interest rates and deal size), time data (eg, optional redemption rates) and reference data (eg, ISIN data) are identified as information that may be expected to be finalised post-pricing.

- **Underlying exposure documentation**: There had been some confusion as to whether the obligation under Article 7(1)(b) to make available "*all underlying documentation that is essential for the understanding of the transaction*" requires reporting entities to make available underlying exposure-level documents such as facility agreements, Intercreditor agreements, hedging documents, etc. The ESAs have clarified that whether an underlying exposure-level document is "*essential for the understanding of the transaction*" (and therefore disclosable) will depend on the nature of the transaction. They acknowledge that, often, such documents will not be essential for the understanding of a securitisation. However, a different view might be taken in, for example, a transaction with only a few large underlying exposures.

- **STS requirements for transaction documentation**: Article 21(9) provides that in order for a securitisation to be considered "standardised", certain information must be clearly specified in the transaction documents, including provisions relating to the delinquency or default of debtors, priorities of payments, etc. Any change in the priorities of payments which will materially adversely affect the repayment of the securitisation provision must be reported to investors without delay.

  The ESAs explained that it is for the originator and sponsor of a securitisation to confirm compliance with this provision and the required information must be included under a specific section in the transaction prospectus. The ESAs go on to say that the information specified in Article 21(9) relating to servicing procedures should be found in a publicly available document, so as to facilitate investors' due diligence of the transaction. This is especially the case where the document explains how the servicing of delinquent and defaulted exposures are taken care of.

- **STS+ certification**: The final question relates to the provision of "STS+" certification (that is, certification as meeting not only the STS requirements set out in the Securitisation Regulation, but also the additional criteria required for preferential treatment under legislation such as the CRR and the LCR Delegated Regulation) by third-party verifiers (**"TPVs"**). The ESAs have clarified several points in relation to TPVs providing STS+ certifications:
  - The provision of STS+ certification assessments should not be considered as the provision of advice to the originator, sponsor or SSPE of a securitisation within the meaning of Article 28(1)(c) of the Securitisation Regulation. The assessment of compliance with the relevant provisions of the CRR and LCR Delegation Regulation is considered ancillary to the main service of STS verification.
  - TPVs must notify their competent authorities of the provision of any STS+ assessments, as this is regarded as a material change to the information that a TPV is required to provide to the competent authority under Article 28(1).
  - The ESAs do not consider that the provisions of STS+ certification services should generally require additional specific governance arrangements beyond those required by Article 28(1). However, the ESAs go on to say that an STS+ TPV should confirm to its competent authority that the provision of such services does not contravene Article 28(1)(c). The ESAs also appear to suggest that, on the basis of Article 28(1), any fees charged for STS+ certification services should be non-discriminatory and cost-based.



Conclusion

The Amendments, Opinion and Q&As provide much food for thought for market participants and their legal advisors. The industry will welcome the Amendments, which should better allow securitisations to facilitate the recovery and growth of European economies as they enter the unprecedented post-pandemic era.

The Q&As, though short, provide helpful clarity on a number of questions that have been the subject of considerable uncertainty. The Opinion also gives some interesting insight into the likely priorities of regulators as they undertake a general review of the Securitisation Regulation later this year.

However, the Opinion also poses some difficult questions for the industry to grapple with. In particular, EU institutional investors may be concerned by the suggestion that their ability to invest in third country securitisations could be subject to those third countries having equivalent securitisation transparency regimes. It remains to be seen whether the proposals set out in the Opinion are implemented in the coming months, either through interpretive guidance from the European Commission or through amendments to the Securitisation Regulation.

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