THE EU SECURITISATION REGULATION – DO I NEED TO WORRY?

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

In this briefing, we provide an overview of the Regulation, with a focus on the situations where a transaction may be brought into scope. We also provide a brief overview of the consequences of being brought into scope.

Key issues

- The regulation of securitisation in the EU has just been completely overhauled, effective 1 January 2019
- That overhaul includes bringing into regulation a large number of entities who were previously unregulated – including UCITS and pension fund investors, as well as non-EU AIFMs who sell into the EU.
- The broad investor due diligence requirements mean the non-EU securitisations need to comply if they are to be sold into the EU.

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

- repeal the main securitisation provisions in existing sectoral legislation applicable to banks (the Capital Requirements Regulation, or "**CRR**"), insurers (Solvency II) and fund managers (the Alternative Investment Fund Managers Directive regime) and recast those provisions in a new, harmonised securitisation regime applicable to all institutional investors including UCITS and pension funds; and
- introduce a concept of "simple, transparent and standardised" (or "**STS**") securitisation that receive more benign regulatory treatment than other securitisations.

In addition to these two high-level measures, the Securitisation Regulation legislative package introduced a number of other changes, the most significant of which is severe penalties (including fines of up to 10% of annual net turnover on a consolidated basis) for non-compliance applied to originators, sponsors, original lenders and issuers.[1] Another change (that is actually part a package of amendments to the CRR that accompanied the Securitisation Regulation) is an accidental expansion of the scope of EU securitisation rules applicable on a consolidated basis to EU banks. Although a fix to this has been politically agreed, it is still several months away from being published in the Official Journal and made effective. Until it is, entities that are part of an EU banking group will need to take special care when engaging in securitisation activities – even where there is no other EU nexus to the transaction.

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

As a result of the more onerous obligations, the new securitisation regime will likely lead to more focus on ensuring regulatory categorisation is carefully thought through. Previously, individual compliance obligations were largely on investors, rather than originators, sponsors, original lenders and issuers. This meant that treating a transaction as a securitisation for the benefit of an investor did not add regulatory obligations on sell side entities. In many cases an originator or sponsor was planning to retain a portion of the deal anyway, so giving risk retention undertakings in such circumstances was a small price to pay for increased demand and liquidity in the transaction. This will no longer be the case under the Securitisation Regulation, as determining that a transaction is a securitisation will carry much more onerous obligations imposed directly on sell-side entities. A corollary of this is that it is no longer possible for EU originators and sponsors to securitise their assets in "non-compliant" securitisations marketed exclusively to non-EU investors.

AM I CAUGHT?

What is a securitisation?

For the purposes of the regulation, the EU definition of a securitisation (see box to the right) is neither intuitive, nor designed to line up with the definition in the United States. For US purposes, a securitisation is only present where there is (i) a security; and (ii) that security is backed by a pool of self-liquidating financial assets. While there can be some uncertainty around the details, the US definition has the virtues of being both relatively clear and of lining up pretty sensibly with the intuitive sense most people in the market would have.

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

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

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

The Securitisation Regulation definition of a "securitisation"

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

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

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

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

The technical definition breaks down as follows:

A pool of underlying exposures

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

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

The Securitisation Regulation definition of a "tranche"

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

Tranching

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

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

Less obviously, deals generally won't be securitisations for EU purposes where tranching arises by operation of law rather than contract (e.g. creditors recovering before shareholders), by structural subordination or where the transaction is time (and not credit) tranched. These rules need to be considered carefully, however, as regulators have made clear they will not tolerate attempts to game the definition (e.g. using preference shares that operate like debt to avoid "contractual" tranching).

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

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

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

The specialised lending exception

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

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

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

Who is caught?

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

Originator

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

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

Sponsor

The definition of sponsor is somewhat more difficult and was originally designed largely for the ABCP market. Broadly, it's an entity that sets up and manages a securitisation but who does not actually securitise its own assets. Historically, an entity has only been capable of being a "sponsor" if it had one of a limited number of EU regulatory permissions, but it looks as though regulatory clarification may be provided in respect of the Securitisation Regulation which will provide comfort that third country (i.e. non-EU) sponsors are allowed. This, in turn, may facilitate risk retention for non-EU CLO managers.

Institutional investor

Wanting to market to "institutional investors" will probably be the most common reason a non-EU securitisation will need to comply with EU securitisation rules. This is because all entities that fit within the definition of an "institutional investor" are subject to due diligence rules under the Securitisation Regulation which require that they check for compliance with many of the other provisions of the Regulation. The universe of investors subject to such regulatory diligence rules has also been significantly expanded under the Regulation. As noted above, historically this has been limited to EU-regulated banks (including investment firms), EU-regulated insurers (including reinsurers) and alternative investment fund managers ("**AIFMs**") either established in the EU or with a full EU passport. Under the Securitisation Regulation, non-EU AIFMs appear to be covered in respect of any fund marketed into the EU (even on a private placement basis into a single country), as are UCITS funds (including UCITS management companies) and EU pension funds (including their appointed investment managers).

I'M CAUGHT BY THE NEW RULES: WHAT NOW?

The Securitisation Regulation recasts the main regulatory obligations associated with securitisation. Under the Securitisation Regulation, any originator, sponsor, original lender or issuer involved in a securitisation[2] will be subject to a raft of obligations regardless of their status as regulated entities or otherwise. The obligations recast can be broken down into three main categories: risk retention, transparency and due diligence. We summarise these obligations (and break down the differences between the previous EU rules and the new ones) for each of these categories in table format below. For further discussion of the detailed rules, please see our recent briefing "The EU Securitisation Regulation – entering a brave new world"[3].

Risk retention

	Old Securitisation Framework[4]	**Securitisation Regulation**
Nature of retention obligation	Indirect.[5] EU regulated investors must check compliance. No direct obligation on retainer to retain, and retention can be avoided where there is no need to make the deal eligible for EU regulated investors.	Direct and indirect. One of originator, sponsor and original lender has a direct obligation to retain. They must agree who will hold retention, with originator being the "fallback" retainer in the absence of agreement.

[2] In general this will only apply directly where the relevant entity is established in the EU, but compliance with most of these obligations will have to be checked by institutional investors as part of their regulatory due diligence. As a result, non-EU entities will often end up indirectly caught in any case, and arrangers for European-marketed deals may want this to form part of the contractual obligations of non-EU entities.
[3] https://www.cliffordchance.com/briefings/2019/01/the_eu_securitisationregulationentering.html
[4] For these purposes, we are referring to the previous risk retention obligations under the CRR, AIFMD/AIFMR and Solvency II.
[5] Note, however, that market participants would typically require contractual obligations on relevant "sell" side parties in transactions marketed to EU regulated investors.

		EU regulated investors must also check compliance.
Retention rate	5%	Unchanged
Retention methods	5 accepted methods, including vertical slice, originator share, random selection, first loss (portfolio), or first loss (asset-by-asset)	Unchanged
Eligible retainers	Originator, sponsor, original lender	Unchanged, except that "sole purpose" originators who exclusively exist to securitise assets are now banned from retaining risk.
Adverse selection test	None, save the general CRR obligations not to engage in adverse selection.	Securitised assets should not be chosen such that they perform significantly worse than "comparable assets held on the balance sheet of the originator" over the life of the transaction (to a maximum of 4 years). Sanctions apply if they are and this is the intention of the originator.
Retention on a consolidated basis	Only for EU-regulated financial groups.	Unchanged.

Transparency

	Old Securitisation Framework[6]	**Securitisation Regulation**
Source of disclosure obligations	Prospectus Directive, Transparency Directive, stock exchange rules, CRR, Solvency II, AIFMR, central bank liquidity scheme rules, as appropriate to the particular transaction.	Securitisation Regulation. Prospectus Directive (or Prospectus Regulation, from 21 July 2019), Transparency Directive, stock exchange rules, central bank liquidity scheme rules continue to apply as appropriate.
Nature of disclosure obligations	A combination of direct (on the sell side) and indirect (on regulated investors to diligence certain specific information). Information investors are required to diligence does not necessarily marry up with information sell side is required to disclose. Which disclosure/diligence obligations apply depends heavily on regulated status of originator, sponsor, original lender and investors. Depends also whether there is a public offer, whether and where the transaction is listed, and whether central bank liquidity scheme eligibility is desired. Potential to avoid most detailed/public disclosure obligations, where so desired.	Direct and indirect. Direct disclosure obligations apply regardless of regulated status of originator, sponsor or issuer/SSPE. EU regulated investors required to diligence information that broadly mirrors what originator, sponsor and SSPE are required to disclose. Detailed disclosure required in all cases, regardless of whether the transaction is public or private transactions. Securitisation Regulation disclosure obligations sufficiently detailed and onerous as

[6] For these purposes, we are excluding obligations under Article 8b of the Credit Rating Agencies' Regulation and the associated regulatory technical standards. Although these obligations were formally in force and applied for two years, they were never capable of being complied with so they were not *de facto* applicable.

		to make others (bar the prospectus obligations) largely negligible.
Audience for disclosure	Depends heavily on factors listed above. Potential to avoid most detailed/public disclosure obligations, where so desired.	In theory, only to investors, competent authorities and, upon request, to potential investors. In practice, private transactions may be able to stick to this, but public transactions will end up disclosing to the public at large. See next row.
Mechanism for disclosure	Depends heavily on factors listed above. Potential to restrict disclosure of information to private/specifically negotiated means where so desired.	Public transactions (i.e. where a prospectus is required to be published under the Prospectus Directive) must disclose to a regulated securitisation repository or (where none exists) on a website meeting certain prescribed standards. Private transactions do not have a prescribed mechanism for disclosure provided investors, competent authorities and, upon request, potential investors can access information. Certain national competent authorities ("**NCAs**") may prescribe the method, frequency and content of information to be reported to them on private transactions.[7] Parties will need to check the approaches of the relevant NCA(s).
Content that must be disclosed	Depends heavily on factors listed above. Potential to restrict disclosure of information to specifically negotiated items where so desired.	Full documentation essential for the understanding of the transaction, including prospectus or (where there is no prospectus) a deal summary, loan level data on a prescribed template, investor reports on a prescribed template, reports of any significant events/material changes on a prescribed template. Additional items such as the STS notification (in prescribed format), a liability cash flow model and (where available) environmental data must be disclosed for STS securitisations.
Frequency of disclosure	Depends heavily on factors listed above. Potential to restrict disclosure of information to specifically negotiated items where so desired.	Full transaction documents, prospectus/deal summary and (where appropriate) STS notification and liability cash flow model before pricing. Loan level data and investor reports quarterly (or monthly for ABCP). Significant events/material changes to be reported without delay.

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

Due diligence

	Old Securitisation Framework[8]	Securitisation Regulation
What type of institutional investors are in scope	Credit institutions, investment firms, alternative investment fund managers, insurers and reinsurers.	As with current framework, plus pension funds, internally managed UCITS and UCITS management companies. Non-EU AIFMs marketing in the EU on the basis of national private placement regimes may now also be covered.[9]
Specific items to be diligenced	Vary somewhat from regime to regime. Not well-matched to information otherwise required to be disclosed by the sell side. The AIFM regime requires diligence of the credits granted by the originator/sponsor generally, not just the assets securitised.	Harmonised for all types of institutional investor. Generally limits diligence to the underlying assets of the securitisation and the behaviour of the entities involved in respect of the underlying assets. New requirement to establish written procedures to monitor ongoing compliance.
Requires verification of compliance with direct disclosure obligations?	No. Requires only that the investor be able to check the specific items it must verify under the legislation.	Yes. Investors required to check that all information required to be disclosed has been disclosed, even where not otherwise relevant for diligence procedures.[10] Investors required to diligence the STS notification (where relevant) even where STS status is not relevant to their investment decision.
Right to delegate diligence obligations	Never officially provided for or formally sanctioned. Was nonetheless common practice, but with uncertain legal consequences if diligence was not carried out to the legally required standard.	Formal authorisation for institutional investors to delegate the obligation to carry out regulatory diligence to a third party. Applies only where that third party is itself an institutional investor and makes investment decisions on behalf of the principal.
Secondary legislation to clarify diligence obligations	Yes. Under CRR these were combined with the risk retention RTS and were a useful way of clarifying, in particular, that a proportionate approach could be taken to compliance, which facilitated e.g. the operations of bank trading desks.	No secondary legislation provided for. Institutional investors will need to speak to their regulators and consider their own approaches. This has presented a number of challenges for institutional investors, especially with respect to proportionality issues.

[8] For these purposes, we are considering only securitisation-specific diligence obligations.
[9] This concern arises from the definition of "institutional investor" in the Regulation that includes any AIFM that "manages and/or markets alternative investment funds in the Union". Clarification has been sought from ESMA as to whether this intended to cover any marketing or only marketing based on an AIFMD passport. Until that clarification is issued, many large AIFMs are taking the cautious approach that any marketing, including marketing in reliance on so-called Article 42 registrations, would be sufficient to bring them into scope.
[10] The obligation to check compliance with EU disclosure obligations (at Art. 5(1)(e) of the Regulation) is oddly worded, leading some to argue that EU institutional investors need not check that Article 7 disclosure obligations are complied with by third country originators, sponsors or issuers. This approach seems fundamentally at odds with the policy objectives of the diligence obligations, but clarification has been sought from the authorities.

CONCLUSION

The application from 1 January 2019 of the EU Securitisation Regulation significantly expands the universe of entities subject to EU securitisation rules and, thereby, the universe of transactions that will need to comply. Unfortunately, this expansion in scope has been accompanied by a more onerous set of securitisation rules and the introduction of much more serious penalties for failure to comply. Consequently, an increased focus by market participants on identifying securitisation activity is likely, with transactions structured not to be securitisations (or not to involve in-scope entities) where possible, and robust compliance processes put in place where an in-scope securitisation is entered into.

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