The new European securitization framework – key challenges

What is the new European securitization framework?

The new European securitization framework applies to securitization transactions entered into on or after 1 January, 2019. The framework has been implemented by two regulations (together with a number of delegated regulations):

- Regulation (EU) 2017/2401 amending the CRR relating to prudential requirements for credit institutions and investments firms (the **CRR Amending Regulation**); and
- Regulation (EU) 2017/2402 providing a general framework for securitization and a specific framework for STS securitizations (the **Securitization Regulation**).

Principal objectives

The Securitization Regulation achieves the following principal objectives:

- repeal the main securitization provisions in existing EU regulations applicable to credit institutions (the **CRR**), insurers (**Solvency II**) and fund managers (the **AIFMD** and the **AIFMR**) alternative investment fund managers directive regime) and houses these into a new uniform regulation applicable to all institutional investors including UCITS and pension funds; and
- introduce a concept of *"simple, transparent and standardized"* (**STS**) securitization that will benefit from a more favourable capital treatment for the investors as compared to non-STS other securitizations.

The CRR Amending Regulation largely implements the revised Basel securitization framework and has introduced a more risk sensitive prudential treatment for STS securitizations.

The great divide - are all securitizations required to have an STS designation?

The Securitization Regulation broadly contains two categories of provisions:

General provisions

The general provisions contain new duties and principles applicable to all securitizations. They are aimed at addressing issues and deficiencies experienced in the past in securitization transactions. Provisions under this category include the following:

- Definitions
  - the definition of "securitization" used in the CRR has been replicated into the Securitization Regulation with the addition of a new limb to make it clear that any transaction which creates *"specialized lending exposures"* in accordance with Article 147(8) of the CRR is not a securitization for these purposes (which reflects recitals to this effect from earlier legislation); and
  - the definition of "sponsor" has been broadened, most significantly to include non-EU investment firms (as well as non-EU credit institutions).
- Due diligence requirements for investors
  - the Securitization Regulation sets out harmonized due diligence requirements that apply to "institutional investors". "Institutional investors" is defined to include credit institutions, investment firms, insurers, reinsurers and alternative investment fund managers (to whom rules relating to exposures to securitization transactions already applied under pre-existing financial services legislation), as well as UCITS and pension funds; and

  - institutional investors must establish written procedures in order to monitor the performance of a securitization position and its underlying exposures and be able to demonstrate to its competent authorities, upon request, that it has a comprehensive and accurate understanding of the securitization position and of the underlying exposures.

- Transparency requirements for originators/sponsors/securitization special purpose entities (**SSPEs**):
  - the originator, the sponsor and the SSPE must designate between themselves, one entity (a **Reporting Entity**) to fulfil reporting requirements under the Securitization Regulation;
  - the Reporting Entity must be identified in the transaction documentation;
  - the Reporting Entity must make the relevant information available by means of either filing such information with a securitization repository or, if no such repository exists, on a website meeting certain safety and operational requirements as provided for by the Securitization Regulation; and
  - reporting obligation must be periodic (at least quarterly).
- Risk retention
  - under the Securitization Regulation, originators, sponsors and original lenders will be under a direct obligation to retain a five per cent net economic interest in securitization transactions. As a result, EU originators and sponsors will need to

satisfy the risk retention requirements even where there is no requirement from investors to do so (e.g. because they are non-EU entities); and

– originator: The Securitization Regulation specifies that, for the purpose of satisfying the risk retention rules, *"an entity shall not be considered to be an originator where the entity has been established or operates for the sole purpose of securitizing exposures"*. Details of how compliance with this requirement can be achieved will be included in a new set of regulatory technical standards (**RTS**) on the risk retention requirements which are in the process of being adopted by the European Commission, and will replace the current RTS under the CRR.

- Ban on resecuritization
  – Securitization transactions where the underlying exposures include securitization positions are prohibited except in limited circumstances ("legitimate purposes"), including where the securitization is used to ensure the viability as a going concern of a credit institution, investment firm or financial institution (or to facilitate its winding-up), or to preserve the interest of investors where the underlying exposures are non-performing. Fully supported ABCP programs will not be classified as re-securitizations for the purposes of the prohibition, provided that none of the ABCP transactions within the relevant program is a re-securitization and that the credit enhancement does not establish a second layer of tranching at the program level. However, the express exemption of certain ABCP programs from the ban has raised some concerns that in other contexts ABCP programs could be treated as re-securitizations which could have severe consequences on the capital treatment of ABCP.
- Criteria for credit-granting
  – originators, sponsors and original lenders must apply to the receivables to be securitized the same *"sound and well defined"* criteria for the credit-granting which they apply to non-securitized exposures, with the exception of trade receivables if not loans; and
  – for portfolio acquisitions which are securitized, the securitization originator must verify that the original lender has applied the same criteria for credit-granting that the originator is required to apply (subject to some exceptions for loans granted before the entry into force of the Mortgage Credit Directive). This requirement may prove problematic where records are no longer available or the loans have changed hands a number of times.

STS provisions

The Securitization Regulation draws a distinction between securitizations which meet the STS criteria and those that do not. The main benefit of a securitization complying with the STS criteria is preferential regulatory capital treatment. The liquidity coverage ratio (**LCR**) requirements under the CRR and the provisions of the Solvency II Delegated Act relating to the capital treatment of securitizations have also been amended to reflect the final STS criteria and to adjust regulatory capital treatment to take account of the new STS

securitization label. The amendments to the LCR requirements under the CRR and the relevant provisions of the Solvency II Delegated Act will apply with effect from April 2020. However, there is no grandfathering under either the CRR or the Solvency II Delegated Act for transactions that were entered into prior to the date the amendments apply. The effect of this is that whilst transactions that are STS securitizations will be able to satisfy the new LCR and Solvency II requirements, investors investing in non-STS transactions will not be eligible for preferential regulatory capital treatment under the amended legislations, even if they were eligible for such preferential treatment prior to the date of application of the new requirements.

In order to be designated an STS securitization, in addition to the general provisions applicable to all securitizations summarized above, transactions have to comply with additional STS criteria.

These include:

- Simplicity requirements
  - The originator/sponsor/original lender must ensure simplicity of the transaction structure and homogeneity of the securitized assets. "Homogeneous" for these purposes means being in the same asset type where the contractual, credit risk, prepayment and cash-flow related characteristics are sufficiently similar. Detailed homogeneity requirements are set out in technical standards which have not yet been adopted by the European Commission
- Transparency requirements
  - The originator/sponsor/original lender must ensure the availability of sufficient information on the securitized assets, transaction structure and parties involved in the transaction. These transparency requirements go beyond the general disclosure obligations and include disclosure of static and dynamic historical default and loss performance data, an external verification of a sample of the underlying exposures and a liability cash flow model.
- Standardization requirements
  - The originator/sponsor/original lender must ensure that investors are able to understand and compare securitization transactions without relying on third party assessments. The standardization criteria include, among other matters, requirements for key provisions in documentation and servicer expertise.

STS notification – summary of procedure

In order to obtain an STS designation, transactions that meet the requirements of the Securitization Regulation must be notified to the European Securities and Markets Authority (**ESMA**).

- *Who is required to make the notification?* The originator and sponsor are jointly responsible for making the notification of the STS designation to ESMA, and may face the consequences for falsely making such a designation. The Securitization Regulation sets out an optional process whereby an authorized third-party can verify the satisfaction of the STS criteria. While use of the third party verification should support an argument that the originator, sponsor and issuer did not negligently breach the STS criteria, it does not remove liability from the originator, sponsor and issuer for the designation of the transaction as STS.
- *How is the notification to be made?* Through the ESMA notification template and sent electronically according to the procedures to be established by ESMA.
- *Content of the notification* The STS notification must include a confirmation that the transaction complies with the criteria laid down by the Securitization Regulation, an explanation (by the originator and sponsor) of how each STS criterion has been satisfied and the additional information required in the STS notification templates published by ESMA. Originators and sponsors are required to store information sent to ESMA for at least five years and correct errors once identified without delay.
- *Publication of notification* ESMA will publish the STS notification on its official website. The Originator and the Sponsor of a securitization shall inform

the respective competent authorities of the STS notification and designate among themselves the person acting as the first contact person for the investors and the competent authorities. The UK's FCA has issued a direction stating that a copy of the STS notification should be sent to it at the same time as, or as soon as possible after, making the STS notification to ESMA.

- *Loss of STS requirements*
  If a securitization no longer meets the requirements of the Securitization Regulation, the originator and the sponsor must immediately notify ESMA and inform the competent authorities.
- *Interim STS notification reporting and templates*
  ESMA cannot establish the official register for STS notifications until the final technical standards on STS notifications are published in the Official Journal and apply. In light of this, ESMA has published interim STS notification reporting instructions and related templates and has requested that notifications are reported to its interim register until its official register is established.

Penalty for non-compliance

Under the Securitization Regulation, originators and sponsors could face a variety of administrative and criminal sanctions depending on how the Securitization Regulation is implemented in each Member State. The imposition of the administrative and criminal sanctions must take into account whether the infringement was intentional or resulting from negligence, and the materiality, gravity and duration of the infringement. The wide discretion vested in the Member States in implementing the sanctions regime for non-compliance with the Securitization Regulation may result in differing sanctions applying across Member States, which creates further uncertainty in relation to implementation when it comes to cross-border transactions.

In addition, in line with the regime in force prior to the coming in force of the Securitization Regulation, regulated investors who fail to conduct the appropriate due diligence will be subject to increased capital charges.

Key challenges

Availability of data and information

Availability of data

The Securitization Regulation requires that, prior to pricing of an STS securitization, the originator and the sponsor shall make available to potential investors, historical data on static and dynamic default and loss performance data of receivables substantially similar to those to be securitized for a minimum period of 5 years. Without such data, a transaction will not be able to obtain an STS designation. The primary challenge faced in terms of historic data is that new originators in the market and originators originating new asset classes or new products within an asset class would potentially struggle to provide historic data or performance data for "receivables substantially similar to those to be securitized" for five years. Without such data, a transaction cannot be STS compliant.

Presentation of information

The Securitization Regulation provides for technical standards to specify the form and content of loan-level reporting templates and investor reporting templates. In order to comply with the Securitization Regulation, market participants may need to invest in additional resources (including new software and business processes) in order to be able to provide information in the form required by the new reporting templates, increasing the costs involved in entering into securitization transactions. Further, the risk involved in manually having to change the format in which data is presented increases the chance of mistakes and therefore gives rise to liability issues for these participants. These requirements extend to private and bilateral transactions (e.g., warehouse facilities).

In the ESMA Opinion (as such term is defined below), ESMA has indicated that it has tried to address some of the issues raised above by making minor adjustments to certain template fields and also by increasing the number of fields that may use "No Data" options. It remains to be seen if these will be sufficient to address the significant market concerns.

Absence of level 2 legislation

Whilst the Securitization Regulation came into force on 1 January, 2019, the technical standards that are essential to interpret and implement the Securitization Regulation are yet to come into force. It is expected that most of the technical standards (including those relating to STS notifications, third party verifiers, risk retention and homogeneity) will be published during the first quarter of 2019, but this still remains uncertain. The technical standards relating to disclosure have been further revised by ESMA and are now with the European Commission for review. Given the timeframes for the EU legislative process, it is

possible that the disclosure technical standards will not be published in the Official Journal until the second quarter of this year. It is also anticipated that the technical standards may be supplemented by recommendations and official Q&As.

The absence of final technical standards creates considerable uncertainty and additional risk for investors, originators and other market participants, particularly given the sanctions that exist for non-compliance with the requirements of the Securitization Regulation. Whilst the absence of the homogeneity RTS impacts upon the ability for transactions to be characterized as STS compliant, the absence of the RTS relating to disclosure and risk retention may well affect the ability of market participants to enter into transactions that comply with the mandatory provisions of the Securitization Regulation, particularly as a result of the additional complexity created by the transitional provisions of the Securitization Regulation, which provide for the pre-existing risk retention RTS under the CRR and the templates under the Article 8b RTS to be applied in such circumstances.

Delay in publication of Disclosure RTS

ESMA has been tasked with revising the forms of the disclosure technical standards, specifically, though not exclusively, in relation to no data options in ABCP templates. On 31 January, 2019, ESMA published an opinion containing a revised set of draft technical standards (the **ESMA Opinion**). Since these are yet to be adopted by the European Commission, the final form of the templates may still differ from those published in January 2019. It also remains to be seen whether the European Commission will implement a phasing-in period for the reporting templates, requiring increasing compliance with the templates over a period of time, similar to that which applied in relation to the ECB loan level templates when initially implemented.

Article 43 of the Securitization Regulation contains transitional provisions which provide for compliance with the CRA 3 templates until the disclosure technical standards are published and in force. Unfortunately, the provisions of Article 43(8) of the Securitization Regulation do not import the helpful CRA 3 recitals as well, which, for example, made clear that the templates did not need to be completed for private and bilateral securitizations.

The European Supervisory Authorities (the European Banking Authority (the **EBA**), the ESMA and the European Insurance and Occupational Pensions Authority, collectively the **ESAs**) published a statement noting the difficulty and cost some originators may face in reporting on the basis of the CRA3 templates and asking competent authorities to exercise their supervisory powers in this regard in a risk-based manner. The ESAs did make clear though, that they were not able to authorise general forbearance.

Until the relevant technical standards come into force, those market participants who are required to comply with the Securitization Regulations may wish to comply with the provision of information required by the CRA 3 templates as far as possible. The primary challenge in taking this approach is that the CRA 3 templates were not designed for private transactions and there are only templates for a limited number of asset types. In completing the CRA3 templates, it would be advisable for market participants to conduct a gap analysis to assess how many fields they can and cannot provide information for and then provide explanations for why incomplete fields cannot be completed. This approach should hopefully be sufficient, in the absence of the final disclosure technical standards and templates, to satisfy competent authorities of an entity's good faith efforts to comply, in line with the ESA's statement.

The absence of disclosure RTS impacts all securitization transactions and not just those seeking an STS designation.

Whilst in relation to a public securitization, the information is made available by way of the securitization repository and the prospectus would satisfy certain of the disclosure requirements applicable in relation to the Securitization Regulation, questions remained as to the manner in which a private securitization should satisfy the reporting requirements to make the relevant information available to potential investors and competent authorities.

In relation to private securitizations, the United Kingdom's PRA and FCA have issued a direction which specifies a short-form report to be submitted to them in relation to ABCP and non-ABCP transactions at the times specified in the direction. In the United Kingdom, this is a welcome clarification of what information is required to be reported to the competent authorities in order to comply with the Securitization Regulation. The originator/sponsor will still need to prepare the full set of information required by Article 7 of the Securitization Regulation although it only needs to provide such information to the PRA / FCA on request.

Article 7 of the Securitization Regulation requires the originator, sponsor and issuer to, in relation to securitizations where no prospectus is required to be published, make available to investors, competent authorities and, upon request, to potential investors, a transaction summary or overview of the main features of the securitization. To demonstrate compliance with this requirement, market participants in private transactions are taking the approach of updating the term sheet to reflect the final terms of the transaction and making that available.

Delay in publication of Risk Retention RTS

The European Commission has not adopted the risk retention RTS. Whilst the transitional provisions of the Securitization Regulation specify that the existing RTS applicable to the CRR should be followed until such time as the new risk retention RTS apply, this poses two primary challenges:

- Risk retention provisions are required to be put in place at the time a transaction is entered into and are meant to comply with the risk retention rules during the life of the transaction. It is not clear whether transactions entered into during the period from the date of application of the Securitization Regulation (i.e., 1 January, 2019) until the risk retention RTS come into force will be grandfathered. To the extent the final risk retention RTS are more onerous than the RTS applicable under the CRR, there is a risk that transactions seeking to rely on the CRR RTS might need to be unwound following the adoption of the new standards; and
- Most market participants will not want to take the risk of their transactions falling foul of the risk retention rules and may therefore delay the transaction until such time as the detailed rules are published.

The delay in publication or risk retention RTS impacts all securitization transactions and not just those seeking an STS designation.

Delay in publication of Homogeneity RTS

The final RTS relating to homogeneity (which are applicable to STS transactions) have not yet been published in the Official Journal and there is increasing concern that the European Commission may make further revisions to the RTS. Further, no transitional provisions have been put in place in this regard. This delay impacts only transactions seeking STS designation.

Without such RTS, it is difficult to enter into any transactions which are designated as STS as failure to meet the homogeneity requirements once finalized would result in a transaction not being STS-compliant.

It should also be noted that while transactions entered into prior to 1 January, 2019 can be re-classified as STS (provided they meet the requirements specified in Articles 43(2) and 43(3) of the Securitization Regulation), transactions entered into after 1 January 2019 which are not designated STS at the time they are entered into cannot then be converted to STS transactions.

Exclusion of certain kinds of transactions

Effective exclusion of certain asset classes

Certain types of securitization are very unlikely to be able to satisfy STS criteria. These include securitizations of non-performing loans, managed CLOs and CMBS. As the Securitization Regulation currently stands, synthetic securitizations cannot qualify for an STS designation (although the EBA is currently preparing a draft STS criteria for synthetic securitizations for review by the European Commission).The Secruritization Regulation mandates the ESAs to prepare a report on the feasibility of a STS framework for balance sheet synthetic securitizations by 18 July, 2018 and that within twelve months the European Commission should present a report and if appropriate a legislative proposal to the European Parliament and European Council based on the eligibility of synthetic securitizations as STS securitizations; therefore a report on a potential STS framework is expected within the next few months.

Exclusion of certain jurisdictions

As the Securitization Regulation does not contain any third country equivalence regime applicable to non-EU parties, any securitization which involves a non-EU originator, sponsor or SSPE will not be able to qualify as STS in the European Union. This is a significant consideration for UK originators (as they will be non-EU parties post-Brexit) and for other non-EU originators.

In the United Kingdom, the draft Securitization (Amendment) (EU Exit) Regulations 2019 allow for the possibility of cross-border STS securitizations post-Brexit. These regulations are aimed at avoiding a situation where EU STS securitizations cease to be recognized as STS securitizations post-Brexit by providing that:

- Securitizations recognized as STS before exit or during a two-year transition period would continue to be recognized as STS in the United Kingdom; and
- Longer term, ABCP programs will be eligible as STS in the United Kingdom, provided the sponsor is established in the United Kingdom (i.e., the SSPE and originator do not have to be located in the United Kingdom). For non-ABCP transactions, both the originator and sponsor

must be established in the United Kingdom for a transaction to be eligible as STS in the United Kingdom from the date of the United Kingdom's exit from the EU.

Acquired portfolios

The Securitization Regulation requires that originators who are securitizing an acquired portfolio verify that the original lender applied sound and well-defined criteria for credit granting to securitized and non-securitized exposures at the time the assets were originated. This will be difficult (if not impossible) to achieve in relation to older portfolios. The original lender may no longer exist or the records required to verify this may no longer be available. While this issue has been brought to the attention of the regulators and it is hoped that guidance enabling the securitization of secondary acquired portfolios will be forthcoming, no guidance has been issued to date in this regard.

The road ahead

It is hoped that the outstanding technical standards are settled in the next few weeks and that the new service providers under the Securitization Regulation (such as securitization repositories and third party verification agents) are authorized as soon as possible thereafter. While the Securitization Regulation largely implements guidelines that were already issued by various industry bodies and codify what was, in many respects, already market practice, without these outstanding steps being completed, there is considerable uncertainty over the scope and application of a number of provisions in the Securitization Regulation which has the potential to negatively impact ABS issuance in Europe, at least in the short-term.

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