Briefing

EU Legislation in Progress

July 2016

European Parliament

Common rules and new framework for securitisation

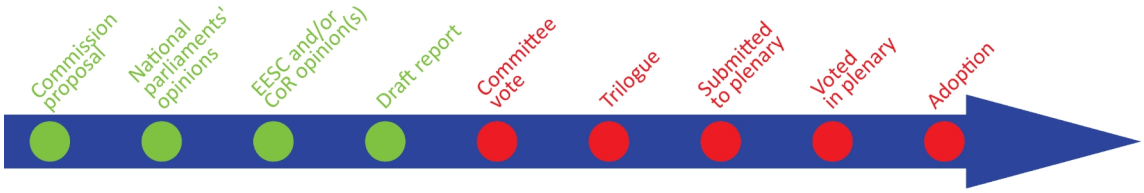
SUMMARY

In autumn 2015, the European Commission proposed, in the context of the Capital Markets Union initiative, a regulation on securitisation. The proposal followed a consultation with stakeholders and took into account initiatives at global (IOSCO) and European levels (EBA). The Commission's aim is to restore investor confidence in securitisation transactions and contribute to reviving the real economy through increased financing and targeted risk allocation. The proposal replaces existing rules relating to due diligence, risk retention, transparency and supervision with a uniform regime. It provides a framework to identify simple, transparent and standardised (STS) securitisations and to allow investors to analyse associated risks. The proposal came as a package with a second proposal, to amend the Capital Requirements Regulation applicable to credit institutions and investment firms in respect of securitisation. In November 2015, the Council agreed its approach on both proposals.

This briefing updates an earlier edition, of February 2016: PE 573.934. See also our updated briefing on the related proposal: 2015/0225(COD).

Proposal for a Regulation of the European Parliament and of the Council laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation and amending Directives 2009/65/EC, 2009/138/EC, 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012

Committee responsible:	Economic and Monetary Affairs (ECON)	COM(2015) 472 of 30.09.2015
Rapporteur:	Paul Tang (S&D, The Netherlands)	*procedure ref.*: 2015/0226(COD)
Next steps expected:	Discussion of amendments and vote in Committee	Ordinary legislative procedure



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Introduction

In the context of its efforts to build a Capital Markets Union, the Commission proposed on 30 September 2015 a regulation which lays down common rules on securitisation, and provides a framework for simple, transparent and standardised (STS) securitisations.

Securitisation refers to the process of packaging and converting loans into securities, which can then be sold to investors. It is an important element of well-functioning financial markets. In contrast to US markets that recovered rapidly from the subprime crisis, European securitisation markets remain subdued, despite the fact that far fewer European securitised products defaulted.

Thus, the aim of the proposal is twofold: to *simplify the current framework for all securitisations* by replacing the various rules on the process with a uniform regime, and to *create a framework to identify simple, transparent and standardised securitisations*, with the final aim to increase investor confidence and restore market activity. This framework is accompanied by an amendment to the treatment of regulatory capital requirements for credit institutions that originate, sponsor or invest in securitisations.

Context

A securitisation transaction involves a number of parties, the most important of which are the original lender, the originator, the sponsor, the Securitisation Special Purpose Entity (SSPE), the underwriter, the credit rating agencies, the third-party credit enhancers, the swap counterparty, the servicer, the trustee, and the investors.

Securitisations are viewed either as 'traditional' or synthetic. A securitisation is viewed as traditional if the assets are effectively transferred to the SSPE and removed from the originator's balance sheet, while it is viewed as synthetic if derivatives are used to transfer only the credit risk of the asset pool – and not the assets themselves − to third parties. The main traditional products are asset-backed securities (ABS) and collateralised debt obligations (CDOs).

When a pool of securities, issued in earlier securitisations, is bought by an originator and securitised again (usually in the form of a collateralised debt obligation), this transaction is called a 're-securitisation'. The main products of re-securitisation are CDOs of ABSs and CDOs of CDOs (CDO^2).

Existing situation

The current legislative framework relating to securitisation is composed of provisions in various areas, including **banking** (Regulation 575/2013 (CRR Regulation) and the 'LCR' Delegated Regulation), **insurance** (Directive 2009/138/EC ('Solvency II') and the Delegated Regulation relative to prudential requirements for insurers), **asset**

management (Directive 2011/61/EU (AIFMD)) **credit ratings** (Regulation 1060/2009 (CRA III)) and finally **prospectuses** (Regulation 809/2004).

The changes the proposal would bring

The proposal applies to securitisations issued as of 1 January 2011, as well as those issued before that date where new exposures have been added or substituted after 31 December 2014. The first part of the proposal harmonises the rules that apply to all securitisations with regard to due diligence, risk retention, and transparency, while the second part sets out the criteria for long- and short-term STS securitisations, as well as rules regarding supervision and sanctions.

Common rules for all securitisations

Due diligence requirements for investors

The regulation would replace, with a single article, the existing rules imposing requirements on investors before they enter a transaction, as well as while they hold a securitisation position. These provisions require investors to verify origination practices; to make sure that the risk-retention provisions are being met; to assess the risk characteristics and structural features of the transaction; to establish written procedures for compliance with the due diligence requirements; to perform stress tests on the underlying cash flows and collateral; to ensure adequate internal reporting; and to be able to demonstrate to regulators that they understand the positions they hold.

Risk retention requirements

While the substance (5% net economic interest) and methods of risk retention remain unchanged, the article would replace the current, 'indirect' approach to retention requirements with a 'direct/indirect'[1] approach. Under the indirect approach, the investor, who usually does not have direct access to the necessary information, had the obligation to check whether the original lender, sponsor or originator had retained the risk. This implied that the EU-established original lender, sponsor or originator could simply ignore EU risk-retention rules if the investor came from a third country. Moreover, the article will define further the notion of 'originator' for the purposes of risk retention, to avoid the possibility of requirements being circumvented via an extensive interpretation of the originator definition in the CRR:[2] entities established or operating 'for the sole purpose of securitising exposures', i.e. SSPEs, would no longer be considered originators.

Transparency requirements for originators, sponsors and SSPEs

The regulation would ensure that both investors holding a securitisation position and the competent authorities have all the relevant information on securitisations at their disposal. It obliges originators, sponsors and SSPEs to make such information freely available, via standardised templates, on a website that meets criteria such as control of data quality and business continuity.

The framework for STS securitisations

The proposed regulation specifies the defining criteria of a new type of securitisation (a 'simple, transparent and standardised', or STS, securitisation). It contains general requirements with regard to simplicity, transparency and standardisation, among others.

Simplicity

Only a securitisation in which the ownership of the underlying exposures is transferred or effectively assigned to an SSPE is an STS.[3] Representations and warranties that the

underlying assets are not encumbered must be provided, and criteria must be in place so that the underlying portfolio of assets is not actively managed. In addition, securitised assets must be homogeneous and must have been originated in the ordinary course of business; re-securitisation is excluded. Lastly, at the time of transfer into the securitisation, no loans should be in default or constitute exposures to credit-impaired obligors, and at least one payment must have been made on the loan.

Transparency

The originator, sponsor and SSPE must provide historical data on default and loss performance to investors. There must be external verification of a data sample by an appropriate and independent party. The originator or sponsor must provide investors with a liability cash flow model, both before pricing the securitisation and on an ongoing basis. Finally, the originator, sponsor and SSPE would be jointly responsible for complying with the transparency requirements of the STS Regulation.

Standardisation

The original lender, sponsor or originator must comply with the aforementioned risk-retention requirement. The interest rate and currency risks must be mitigated and the mitigation measures disclosed. The referenced interest payments must be based on generally used market interest rates. The transaction must provide for early amortisation triggers, revolving transactions must provide the triggers to end the revolving period, and the duties of the ancillary service providers (e.g. swap providers, liquidity facility providers) be clearly specified. In addition, the documentation must set out clearly what actions may be taken in relation to delinquency and/or default of debtors, as well as provide for the timely resolution of conflicts between investors.

Specific requirements for short-term programmes

The proposed regulation also contains specific requirements for shorter-term programmes, i.e. Asset-Backed Commercial Paper (ABCP), at two different levels. At the transaction level, the remaining maturity of underlying exposures must be less than two years, and loans secured by residential or commercial mortgages are not accepted. At programme level, the sponsor must be a bank supervised under CRD IV, issued securities should not include provisions that have an effect on final maturity, and final documentation must be provided to investors at the latest 15 days after close of the transaction.

Notification and disclosure

The disclosure rules imposed on originators, sponsors and SSPEs complement the due diligence obligations imposed on investors. To ensure that originators, sponsors and SSPEs take responsibility for their claim that the securitisation is STS, they should be jointly responsible for compliance with the STS requirements, and for the notification to the European Securities and Markets Authority (ESMA) for publication on its website. Furthermore, they will be liable for any loss or damage resulting from incorrect or misleading notifications under the conditions stipulated by national law.

Supervision

The proposal contains provisions relating to supervision, i.e. the designation and powers of the competent authorities when the parties involved are regulated under EU financial services legislation, when the credit institution is a 'significant credit institution', or when the party concerned is not a regulated entity under EU financial services legislation. In addition, it deals with notification duties, cooperation between

competent authorities in the case of cross-border transactions, and the coordination of authorities by EBA, ESMA and EIOPA.

Sanctions

Lastly, the proposed regulation requires that Member States determine administrative sanctions for breach of the regulation by originators, sponsors, original lenders or SSPEs; these penalties may be as high as €5 million for natural persons or 10% of their total annual turnover for legal entities. Criminal sanctions are left to the discretion of the Member States.

Preparation of the proposal

Following a request from the Commission in January 2014, the European Banking Authority (EBA) finalised on 7 July 2015 advice to the Commission on a framework for qualifying securitisation. In parallel, in the first half of 2015, the European Commission carried out a public consultation on a possible EU framework for STS securitisation. The STS securitisations proposal takes into account the conclusions of the EBA report and the consultation.

Parliament's starting position

The European Parliament has dealt with the issue of securitisation on a number of occasions: in its resolution of 23 September 2008 related to recommendations to the Commission on hedge funds and private equity, it asked the Commission to ensure that the incentives of investors and originators were aligned, by requiring originators to retain a portion of the securitised assets.

In Directive 2009/111, regarding rules on own funds applicable to banks, it secured that investors would only be exposed to the credit risk of a securitisation position if the originators, sponsors or original lenders had explicitly disclosed to them that they would retain, on an ongoing basis, a material net economic interest of at least 5%.

In its resolution of 8 June 2011 on credit rating agencies, Parliament called on the Commission to assess the need to increase disclosure of information for all products in the field of structured finance instruments (including securitisation).

Finally, in Regulation (EU) No 462/2013 on credit rating agencies (CRA III), the Parliament contributed in making sure that CRAs which had entered into a contract for the issuing of credit ratings on re-securitisations, are prohibited from issuing credit ratings on new re-securitisations with underlying assets from the same originator during a period of four years.

Stakeholders' views

The president of the French Banking Federation is reported to have said that, at least in the short term, the proposal may shrink the existing market. Similarly, the managing director of regulation policy at the 'Autorité des Marches Financiers' reportedly[4] warned that the absence in the proposal of an authority that could decide whether a securitisation meets the criteria risks holding back the market. The international non-profit association Finance Watch has noted that the most pressing need for SMEs is to find customers, not to get access to finance, and recalled that securitisation of SME loans is too costly an alternative to traditional bank financing. Moreover, Finance Watch noted that the Commission proposal does not eliminate the possibility of certain synthetic transactions in the STS scheme in the future, which could create significant problems, as the last crisis showed.

On 11 March 2016, the ECB published an opinion on the STS proposal, in which it recommended, among other things, that loan-level data be expressly required in Article 5(1)(a); that the STS notification process explicitly documents, in the summary of the prospectus or equivalent information memorandum, *whether and*, if so, *how* the STS criteria have been fulfilled; enhancements to the cooperation procedures provided for in Article 21 between competent authorities and the EBA, ESMA and EIOPA; a reduction in the types of administrative sanctions available by limiting the extent of fines, the removal of the possibility for Member States to impose criminal sanctions (Article 19), and the imposition of sanctions only in the event of negligence, including negligent omissions, rather than on a strict liability basis.

Lastly, on 23 May 2016, 83 scholars from Europe wrote to the European Parliament to call for careful consideration of the European Commission's proposals for a new market for STS securitisations, part of the Capital Markets Union agenda. Their concerns are fourfold: (i) it is not clear that reviving securitisation would help SMEs, or create growth and jobs; (ii) it is unclear how reviving securitisation would help to diversify risk and make the financial system more stable; (iii) as tranching and credit enhancements are allowed under the STS, the scheme 'would be anything but "simple", "transparent" or "standardised"'; and (iv) the risk retention, as proposed by the Commission, is both too lax and too arbitrage prone.

Advisory committees

The European Economic and Social Committee (EESC) adopted its opinion on the pair of securitisation proposals on 20 January 2016. It stressed that this, still complex, investment product must not be targeted at potentially 'vulnerable' groups, such as small investors and consumers, and requested, for those categories, a formal prohibition to be included explicitly in legislation.

Council

On 30 November 2015, Member States reached agreement within the Council on their general approach to the proposed regulation (and that on capital requirements). In the **preamble**, three important points are added: that even if a sponsor delegates tasks to a servicer, it should remain responsible for the risk management and should not transfer the risk-retention requirement; that securitisation instruments are not appropriate for retail investors; and that commercial mortgage-backed securities (CMBS) should not be considered STS securitisations. With regard to **due-diligence requirements**, the proposal adds provisions for third-country originators, sponsors and original lenders, and extends the obligations to fully supported ABCP transactions. In terms of **transparency requirements**, it extends the necessary information to 'all underlying documentation essential for the understanding of the transaction', and strengthens compliance with legislation governing the protection of confidentiality of information sources and the processing of personal data. It asks original lenders, sponsors and originators to apply the same criteria of **credit-granting** to exposures being securitised as to those not being securitised, and to have effective systems and processes in place to apply them, and asks sponsors to ensure that original lenders comply with the aforementioned criteria. With regard to **STS' simplicity criteria**, it specifies that pools of underlying exposures should only comprise one asset type. As for **standardisation criteria**, it further defines the issue of money 'trapped' in an SSPE after the termination of a revolving period or when there is no such period. On **STS requirements for ABCP** securitisations, it drafts analytically all transaction-level requirements, and adds an

article regulating sponsors of ABCP programmes. In terms of **STS notifications**, it adds (under very strict conditions) the possibility of a third party being authorised by ESMA or national competent authorities to check whether a securitisation complies with STS requirements, and introduces joint liability of the originator, sponsor and SSPE in connection with an STS notification. Finally, the Council text provides that within six months of the entry into force of the regulation, the EBA shall consider the eligibility of synthetic securitisations as STS, and publish a report on the determination of STS **criteria for synthetic securitisations**. Within one year of entry into force, the Commission shall submit a report on the eligibility of synthetic securitisations as STS securitisations, along with the appropriate legislative proposals.

National parliaments

The proposal was discussed by a number of national Parliaments. The scrutiny deadline was passed on 8 December 2015, but none has issued a reasoned opinion.

Parliamentary analysis

In October 2015, EPRS published an in-depth analysis on securitisation. This provides a general introduction to the subject. It describes the principal actors involved in a securitisation transaction, the main securitised instruments and the role securitisation played in the global financial crisis, as well as recent attempts to create a framework for simpler forms of securitisation.

In October 2015, EPRS's Ex-Ante Impact Assessment Unit delivered an initial appraisal of the European Commission's Impact Assessment (SWD(2015) 185 final). The appraisal notes that, while the problem definition is based on extensive analysis and research, it could do more to encourage the exploration of other possible avenues for action beyond the STS denomination. In addition, gaps in the analysis of areas (such as the administrative burden, or the impact on Member States of the STS denomination) may translate into uncertainties related to actual take-up of the STS denomination, especially taking into account that existing national and private labels would continue to exist alongside the EU one.

Legislative process

On 6 June 2016, the draft report by Paul Tang (S&D, The Netherlands) was published, introducing several amendments to the original proposal, including:

The obligation for investors to be institutional investors, and for originators and original lenders to be regulated entities (am. 28, art. 2a)
The prohibition for SSPEs to be established in some 3rd countries with particular characteristics (e.g. off-shore financial centres, am. 29, art. 2b)
A 20% risk retention requirement (am. 40, art. 4)
The extension of article 5 transparency requirements to investors (am.49, art. 5)
The change of the necessary information, from a specific list to all underlying documentation, essential to understand the transaction (am. 50, art. 5)
The addition to the information to be made available of information about the credit granting process for the underlying assets/about the investors in the securitisation, the size of their investment and the securitisation tranche (am. 51/55, art. 5)

The obligation for originator, sponsor and SSPE of a securitisation to provide the information of the aforementioned list to ESMA (am. 56, art. 5)
The establishment by ESMA of a dedicated webpage, the 'European Securitisation Data Repository', where information on underlying loans described in par. 1(a) of article 5 will be stored (am. 56, art. 5)
The prohibition of arbitrage synthetic transactions to qualify as STS (am. 72, art. 8)
The obligation of the originator, sponsor and SSPE to publish information on the long-term sustainable nature of the securitisation for investors (am. 73, art. 10)
The obligation of the originator or the original lender to disclose and publish an explanation of how the capital relief attained through STS securitisation helped to fund new lending (am. 74, art. 10)
With regards to Asset Backed Commercial Paper (ABCP) STS securitisation, the addition of requirements relating to the sponsor of an ABCP Programme (am. 76, art.12)

Following initial discussion in the ECON Committee, the deadline for amendments has been fixed for 20 July, with discussion to resume after the summer.

References

Common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation, European Parliament, Legislative Observatory (OEIL).

Understanding securitisation background – benefits – risks, European Parliament, DG EPRS.

Structured Capital Markets Briefing – October 2015, Baker & McKenzie.

The Proposed Securitisation Regulation, Clifford Chance.

New EU securitisation Regulation: moving in the right direction, Dechert LLP.

Endnotes

[1] The direct approach applies to EU established original lenders, sponsors and originators, while the indirect approach continues to apply to non-EU-established entities.

[2] The current definition of originator in the Capital Requirements Regulation is '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 exposure being securitised; or (b) purchases a third party's exposures for its own account and then securitises them'.

[3] However the Commission notes that it may assess in the future whether some synthetic securitisations could meet the requirements.

[4] *Financial Times,* 'France warns that EU securitisation push lacks ambition', 26 October 2015.

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