

# Common rules and new framework for securitisation

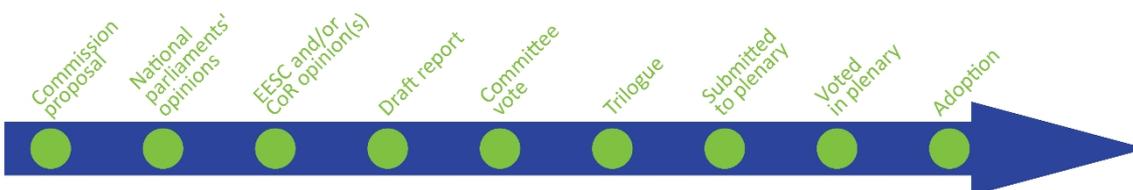
## SUMMARY

In autumn 2015, the European Commission proposed a regulation on securitisation, in the context of the Capital Markets Union initiative. The proposal followed a consultation with stakeholders and took into account initiatives at international (BCBS-IOSCO) and European levels (EBA). 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. During the October II plenary session, the European Parliament is due to vote on the compromise agreement struck with the Council in May 2017.

*This briefing further updates an earlier edition, of July 2016: [PE 586.624](#). See also our updated briefing on the related proposal: [PE 608.778](#).*

**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**

<i>Committee responsible:</i>	Economic and Monetary Affairs (ECON)	COM(2015) 472 of 30.9.2015
<i>Rapporteur:</i>	Paul Tang (S&D, The Netherlands )	<i>procedure ref.:</i> 2015/0226(COD)
<i>Procedure completed.</i>	Regulation (EU) 2017/2402 <a href="#">OJ L 347, 28.12.2017, pp. 35-80.</a>	Ordinary legislative procedure



## 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 're-securitisation'. The main products of re-securitisation are CDOs of ABSs and CDOs of CDOs (CDO<sup>2</sup>).

## 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'<sup>1</sup> 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:<sup>2</sup> 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.<sup>3</sup> [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.

## Legislative process

### 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 will submit a report on the eligibility of synthetic securitisations as STS securitisations, along with the appropriate legislative proposals.

On 8 December 2016, the **ECON Committee** adopted its [report](#) (44 for, 3 against and two abstentions), introducing several amendments to the original proposal.

In the general provisions, the report clarifies the terms 'securitisation position', 'original lender', 'balance sheet synthetic securitisation', 'fully supported ABCP programme', 'non-financial corporation' and 'beneficial owner' (article 2, points (18a-f)); it provides that investors must be institutional investors, and originators and original lenders must be regulated entities, financial institutions whose corporate objective is to provide financial accommodations, or multilateral development banks (article 2a); finally, it prohibits Securitisation Special Purpose Entities from being established in certain third countries with particular characteristics (e.g. off-shore financial centres, article 2b).

In the provisions applicable to all securitisation, the ECON report establishes a 5-10% risk retention requirement, depending on the modality of retention, and entrusts the EBA with reviewing every 2 years the retention rate between 5-20% for the market as a whole, or for certain of its segments, by way of Regulatory Technical Standards (article 4); sets the obligation – at risk of a fine – for an originator, sponsor or original lender to ensure

that losses on the securitised assets over one year are not significantly higher than the losses over the same period on homogenous assets<sup>4</sup> randomly selected from the balance sheet of the originator or original lender (article 4 (1a)); obliges originators, sponsors and SSPEs of a securitisation to provide specific information to investors, prior to their exposure to a position, and investors to provide information to competent authorities (article 5(1) and (1a)). It further provides that a detailed description of the priority of payments, of information about the credit-granting process for the underlying assets and of information concerning the investors in the securitisation, the size of their investment and the securitisation tranche should be added to the information to be made available (article 5(1) and (1a)).

The report inserts a new chapter (2a), in which it sets the conditions and procedures for the registration of a securitisation repository (application for registration, examination of the application by ESMA, notification by ESMA of its decision; powers of ESMA to require securitisation repositories and related third parties to provide information, for it to investigate them, and/or to conduct on-site inspections; supervisory measures that ESMA can take; fines, periodic penalty payments or other measures (e.g. withdrawal of the securitisation depository registration) it can impose (articles 5a-5q). In addition, an amendment would ban re-securitisation (article 5r).

In the chapter regarding simple, transparent and standard (STS) securitisations, the report establishes in the 'general requirements' part the obligation for originators, sponsors and SSPEs involved in an STS securitisation to be established in the EU or in a third country with an equivalence regime (article 6); and the prohibition of [arbitrage synthetic transactions](#) to qualify as STS (article 8 (9a)). With regard to balance sheet synthetic securitisations, once the EBA has clearly determined a set of STS criteria specifically applicable to them, the Parliament proposes to mandate the Commission to draft a report and (if necessary) a legislative proposal in order to extend the STS framework to such securitisations (Recital 16); it further obliges the originator and sponsor to publish information on the long-term sustainable nature of the securitisation for investors, using environmental, social and governance (ESG) criteria to describe how the securitisation contributed to real economy investments and the way the original lender used the freed-up capital (article 10 (3a)). With regard to 'Asset Backed Commercial Paper' (ABCP) STS securitisation, the report adds requirements relating to the sponsor of an ABCP programme –including regular stress testing (article 12a).

In a new chapter, the report sets requirements for securitisation repositories, including requirements relating to operational reliability, to safeguarding and recording information, as well as to transparency and data availability (articles 22a-22e); in this same chapter, it adds provisions relating to the equivalence and recognition of third country regulatory frameworks (article 22f).

Lastly, the report details a specific list of infringements referred to in article 5j (fines), which includes those relating to organisational requirements or conflicts of interest, to operational requirements, to transparency and the availability of information, and to obstacles to supervisory activities (annex 1); as well as a list of coefficients linked to aggravating and mitigating factors for the application of fines in article 5j (annex 2).

On 30 May 2017, an [interinstitutional compromise](#) was reached on the STS file.

In the 'general provisions' chapter, terms such as 'securitisation position', 'original lender', 'fully supported ABCP programme', 'fully supported ABCP transaction' and

‘securitisation repository’ are clearly defined (article 2); the **selling of securitisations to retail clients is not allowed, except under strict conditions** (especially when the financial instrument portfolio of the client does not exceed €500 000 –article 3); and SSPEs cannot be established in some third countries with particular characteristics (article 4).

Chapter 2, which contains provisions applicable to all securitisations, the obligation to verify risk retention (both for when the originator or original lender is established in the EU or in a third country) is added to the due diligence requirements established for institutional investors (article 5). Furthermore, the chapter establishes that the **risk retention must be at least 5 %, measured at the origination and determined by the notional value for off-balance sheet items**. According to another provision, originators must not select assets to be transferred to an SSPE with the aim of rendering losses on those assets higher than the losses over the same period on comparable assets held on their balance sheet (article 6). In addition, the documents that need to be made available to holders of a securitisation position, the competent authorities or investors, need to include a detailed description of the priority of payments of the securitisation. Lastly, the chapter contains special provisions for information requirements in relation to ABCP article (article 7).

The following chapter lays down the conditions and procedures for registration of a **securitisation repository** (registration, notification of and consultation with competent authorities prior to registration or extension of registration, examination of the application, notification of ESMA decisions relating to registration or its extension, powers of ESMA, withdrawal of registration, supervisory fees ESMA can charge the repositories, and availability of data held in the repositories – articles 8-15); **bans re-securitisation** (although there is a derogation for ‘legitimate purposes’<sup>5</sup> and for fully supported ABCP programmes – article 16); and sets criteria for credit-granting (general, as well as specific for those cases where the underlying exposures of securitisations are residential loans, or where an originator purchases a third party’s exposures for its own account and then securitises them – article 17).

The chapter on STS securitisations sets the **obligation for the originator, sponsor and SSPE** involved in a securitisation considered STS **to be established in the EU** (article 18); (in the context of requirements relating to simplicity) and clarifies the ‘severe [clawback provisions](#)’ of article 20, paragraph 1. For ABCP STS securitisations specifically, article 24 (transaction level requirements) is significantly expanded (among other things, provisions relating to the obligation of a true sale, the definitions of severe clawback, cases where the seller is not the original lender, triggers where the transfer of the underlying exposures is performed by means of an assignment and perfected at a later stage, representations and warranties provided by the seller, and prohibition for underlying exposures to include securitisation positions). Also, it establishes that the sponsor of an ABCP programme must fulfil specific criteria, perform its own due diligence and is responsible for compliance with the regulation’s transparency requirements for originators, sponsors and SSPEs (article 25). Lastly, whether it is for an ABCP (article 24) or non-ABCP securitisation (article 20), the title to the underlying exposures must be acquired by the SSPE by means of a true sale.

Articles 27(2)-28 provide for the possibility for an **originator, sponsor or SSPE to use the services of a third party to check whether a securitisation complies with Articles 19-26**, if specific conditions are met.<sup>6</sup> The use of such a service neither affects their liability nor the obligations imposed on institutional investors. Lastly, the powers of the competent

authorities are broadened and the European Systemic Risk Board is explicitly tasked with the macro-prudential oversight of the securitisation market (articles 30-31).

Finally, the entry into force of the regulation is moved back to 1 January 2019.

The agreed text, as well as the one accompanying it (Prudential requirements for credit institutions and investment firms – [2015/0225\(COD\)](#)), was approved in plenary on 26 October 2017, and thereafter by the Council on 20 November. The final act was signed on 12 December, and published in the [Official Journal](#) on 28 December 2017. It will apply as of 1 January 2019.

## References

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

[Prudential requirements for credit institutions and investment firms](#), 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

<sup>1</sup> The direct approach applies to EU established original lenders, sponsors and originators, while the indirect approach continues to apply to non-EU-established entities.

<sup>2</sup> 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'.

<sup>3</sup> However the Commission notes that it may assess in the future whether some synthetic securitisations could meet the requirements.

<sup>4</sup> Homogeneous underlying exposures are those who belong to the same asset type and whose contractual, credit risk, prepayment and other characteristics that determine the cash flows on those assets are sufficiently similar (Art. 8(4)).

<sup>5</sup> For the purpose of the article (a) the facilitation of the winding up of a credit institution, an investment firm or a financial institution, ensuring their viability as going concern in order to avoid their winding up; and (b) where the underlying exposures are non-performing, the preservation of the interests of investors are deemed to be legitimate purposes.

<sup>6</sup> The competent authority withdraws the authorisation 'when it considers the third party to be materially non-compliant with the above conditions'.

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