The Securitisation Regulation: step by step

The adoption of the Securitisation Regulation (the "**SR**") marked the end of a long running consultation and legislative process whereby the European supervisory and governmental authorities, including the European Parliament, set out to reform regulation of securitisation in Europe.

The aims of the legislators were:

- 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.

In addition to harmonising the existing rules and establishing the framework and process for a transaction qualifying as STS, the SR has added a number of new requirements which apply to all securitisations. The special status for "simple, transparent and standardised" ("**STS**") securitisations allows transactions which qualify to benefit from more favourable regulatory status, which may be helpful in creating a deeper and more active market for those transactions.

The SR has also broadened the scope of regulation of the securitisation industry, to directly apply to the main parties involved in establishing a securitisation transaction, and has created a sanctions regime to enforce the rules.

There are a number of Regulatory Technical Standards ("**RTS**") and other guidance under the SR which specify some concrete (and material) points of how the legislation operates. At the date of this article, some of these RTS have been published but others are still in draft form. The European Banking Authority (the "**EBA**") has also published some detailed guidelines, in particular in relation to the STS criteria.

Scope and application – in a nutshell

The SR applies from 1 January 2019 to "institutional investors"[1], originators, original lenders, sponsors, securitisation special purpose entities ("**SSPEs**"), securitisation repositories[2], and third parties authorised to verify STS compliance in accordance with the legislation[3].

Non-EU issuers of securitisations should note that for now, a securitisation cannot qualify as STS unless **all of the originator, sponsor and SSPE are established in the EU**.

Contents

The SR covers, broadly, the following topics:

- general provisions (including a restriction on sales of securitisation positions to retail investors and a restriction on the jurisdictions in which SSPEs may be established);
- requirements for institutional investors (applicable to all securitisations);
- requirements for originators, sponsors and original lenders (applicable to all securitisations);
- criteria and process for transactions to qualify as STS; and
- provisions relating to supervision and sanctions (applicable to all securitisations).

The SR also establishes the conditions and procedures for registration as a securitisation repository.

General provisions

Certain new and specific limitations are imposed on the market by the SR.

- **There is an outright ban on re-securitisations**, subject to limited exceptions which may be available with permission from the relevant Member State competent authority, and to a clarificatory carve-out for fully supported ABCP programmes.
- A new restriction is created on the sale of securitisation positions to "retail clients" (as defined in Directive 2014/65/EU ("**MiFID II**")), unless suitability tests have been undertaken, and in some cases subject to a cap on the amount of such positions as a proportion of the investor's total portfolio.
- There is a new prohibition on SSPEs being established in jurisdictions which are considered high-risk and non-co-operative for the purposes of the Financial Action Task Force, or where any such jurisdiction has not signed an agreement with a Member State to ensure transparency and exchange of information in relation to tax.
- The SR also makes amendments to Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**") to extend certain relief available to covered bond special purpose entities to SSPEs, but only where the related securitisation qualifies as STS. SSPEs of an STS securitisation are exempt from the clearing obligation under EMIR (subject to certain conditions, some of which are set out in a draft RTS which has not yet been adopted) and, pursuant to a draft RTS (which has not yet been adopted), are exempt from posting margin (subject to certain conditions).

1 Ie (i) insurance and reinsurance firms under Directive (EU) 2009/138/EC (Solvency II); (ii) institutions for occupational retirement provision within the scope of Directive (EU) 2016/2341 (subject to certain exceptions) and investment managers or authorised entities appointed in relation to them; (iii) alternative investment funds managers (AIFMs) under Directive 2011/61/EU on Alternative Investment Fund Managers; (iv) internally managed undertakings for collective investment in transferable securities (UCITS) and UCITS management companies; and (v) credit institutions and investment firms under the CRR.

2 To provide the investors with a single and supervised source of the data necessary for performing their due diligence, the designated entity as between the originator, sponsor and SSPE is required to make information available on public securitisations via a securitisation repository, the identity of which needs to be set out in the relevant disclosure. Securitisation repositories can be trade repositories already registered with the European Securities and Markets Authority ("**ESMA**") that have extended their registration to play a role of securitisation repository. The entity must register with ESMA, and must meet certain requirements applicable to trade repositories set out in EMIR (mainly robust governance, operational reliability and safekeeping and recording requirements). At the time of writing, there are currently no securitisation repositories registered with ESMA.

3 The SR provides that such authorised third party should be neither a credit institution, an insurance undertaking or an investment firm, nor a credit rating agency, and the performance of the third party's other activities must not compromise the independence or integrity of its assessment. The SR makes very clear that the involvement of an authorised third party should not in any way shift away from originators, sponsors and institutional investors the ultimate legal responsibility for notifying and treating a securitisation transaction as STS. Third party verifiers are required to be authorised by the Member State's competent authority.

Requirements for institutional investors

The SR builds on the due diligence requirements imposed on institutional investors under the current legislation.

An institutional investor must:

- ensure, before investing, that it has undertaken appropriate due diligence to understand the risk profile of the securitisation position and the underlying exposures, and all of the relevant structural features of the transaction;
- establish appropriate procedures to monitor the investment (including the performance and characteristics of the underlying portfolio at a granular level);
- regularly stress-test the position (and, in the case of fully supported ABCP programmes, the liquidity and solvency of the sponsor);
- ensure that it has appropriate internal reporting in relation to the risks of the position, and
- be able to demonstrate to the competent authority its understanding of the position, risk management and appropriate record keeping.

The SR also retains the so-called "indirect" compliance approach. Before investing, institutional investors are required to verify that the originator, sponsor or original lender has fulfilled its obligations under the SR, in relation to risk retention and disclosure of information, and (in the case of the originator or original lender) certain of the SR's new credit granting requirements (see below). The provisions apply slightly differently depending on whether the originator, sponsor or original lender is established in the EU and are therefore directly subject to the SR or not. There is a specific derogation for ABCP programmes (verification of the credit granting criteria is to be carried out by the sponsor).

Requirements for originators, sponsors, original lenders and SSPEs

For the most part, the SR does not materially change the concepts of originator, sponsor and SSPE. As a reminder, an originator is either (i) an entity "involved in the original agreement which created the obligations or potential obligations of the debtor or potential debtor giving rise to the exposures being securitised" or (ii) an entity "which purchases a third party's exposures on its own account and then securitises them".

It should however be noted that the SR definition of SSPE no longer excludes credit institutions and investment firms. In most transactions, the distinction between an originator and an SSPE will be clear; however, in some cases analysis may need to be undertaken to assess whether a credit institution or investment firm that acquires receivables and refinances such purchase by raising debt does so as an originator or an SSPE. This is particularly relevant for jurisdictions where the application of the banking monopoly requires a purchaser of credit assets to be a regulated entity. Whether the purchasing entity is classified as an originator or an SSPE may make a considerable difference to the application of the legislation to the transaction as a whole.

Risk retention

Article 6 of the SR sets out the risk retention requirements for originators, sponsors and original lenders of securitisations. Broadly, the requirements remain the same as the previous regime: in particular, the prescribed level is still no less than 5%, and the modalities have not changed.

However, the requirement now under the SR applies directly to originators, original lenders and sponsors established in the EU.

The draft RTS relating to risk retention published by the EBA on 31 July 2018 has sought to be generally consistent with the risk retention RTS under the CRR (Delegated Regulation (EU) No. 625/2014), while adding clarifications on certain points.

The most notable adjustment to the risk retention rules under the SR is the codification of the regulatory sentiment that an entity may not be considered to be an originator where the entity has been established or operates for the sole purpose of securitising exposures.

The RTS as drafted includes guidance on the characteristics of an entity which would be considered not to have been established or to operate for the sole purpose of securitising exposures, and can therefore constitute an originator. The following factors should be considered:

- whether the relevant entity has a business strategy and capacity to meet payment obligations consistent with a broader business enterprise and involving material support from capital, assets, fees or other income available to the entity, but disregarding any exposures to be securitised by that entity and any interests retained or proposed to be retained, and any income arising thereof; and
- whether the relevant entity has responsible decision makers with the required experience to enable it to pursue its business strategy, as well as an adequate corporate governance structure.

Until these technical standards are finalised and adopted by the European Commission, originators, sponsors or the original lender should apply the risk retention RTS under the CRR. In practice, however, a "sole purpose" analysis is generally carried out. Many specialist origination businesses may need to take a common sense approach to conclude that the relevant entity has a business strategy consistent with a broader business enterprise, and has income available to meet payment obligations independently of the securitised exposures.

Requirements for origination

The CRR imposed certain standards in relation to credit granting, but only on institutions (as defined in the current CRR: credit institutions and investment firms) acting as originators and sponsors. The SR has developed this

concept in more detail and applies it to all originators, sponsors and original lenders.

There are also a number of new requirements in relation to origination, which will need careful consideration in relation to non-standard origination structures, and purchased portfolios.

Credit granting

The SR imposes the following requirements in relation to credit granting:

1. a requirement to apply to exposures to be securitised the same sound and well-defined criteria for credit granting which the originator, sponsor or original lender applies to non-securitised exposures, including putting effective systems in place to ensure that credit granting is based on a thorough assessment of the obligor's creditworthiness (the former was the CRR origination requirement; the latter is new); and
2. a requirement that where the underlying exposures of securitisations are residential mortgage loans made after the entry into force of Directive 2014/17/EU (the "**Mortgage Credit Directive**", which entered into force on 20 March 2014), the pool may not include any loan that is marketed and underwritten on the premise the information provided by the loan applicant might not be verified by the lender (ie "self-certified" mortgages).

Where a requirement that where an originator purchases a third party's exposures for its own account and then securitises them, that originator must verify that the original lender fulfilled the requirements referred to in paragraph (1) above. By way of derogation from this requirement, where the assets were created before the entry into force of the Mortgage Credit Directive, the purchaser may be excused from verifying that the original lender fulfilled such requirements, provided that the purchaser complies or complied with the equivalent obligation under the CRR, ie it must obtain all necessary information to assess whether the credit-granting criteria applied in relation to the securitised assets were as sound and well-defined as the criteria applied to non-securitised assets.

Institutional investors becoming exposed to securitisation positions must verify the requirement in paragraph (1).

The credit granting requirements would appear to be easier to satisfy in relation to portfolios of regulated consumer credit assets and regulated mortgages originated within the EU, particularly following entry into force of the Mortgage Credit Directive. For older portfolios, and for assets which do not comprise regulated lending or where regulation differs between Member States, more thought may be required in order to conclude that the requirements can be satisfied.

Asset selection

The SR prohibits originators from selecting the assets to be transferred to the SSPE with an aim of rendering higher losses on those assets than on comparable non-securitised assets. An originator in breach of this requirement will be subject to sanction by the competent authority.

Losses are measured over the life of the transaction or, if shorter, four years, and where exposures do perform differently, the SR requires the competent authority to investigate. However, an originator will not be in breach unless the investigation reaches the conclusion that the different performance is "a consequence of the intent of the originator".

The EBA has however usefully confirmed that there is a derogation to this requirement for NPL transactions. The recitals to the SR clarify that the above prohibition does not apply where an originator clearly communicates to investors or potential investors that they have selected assets which *ex ante* have a higher-than-average credit-risk profile compared to the average credit-risk profile of comparable assets that remain on the originator's balance sheet. The draft risk retention RTS specifies that where no communication has taken place, the assessment of the originator's intent will take into account the actions the originator has taken to comply with the prohibition, which includes any policies and procedures which the originator has put in place and applies internally in order to ensure that the securitised assets would reasonably have been expected not to experience higher losses than the losses on comparable assets held on the originator's balance sheet.

The draft risk retention RTS clarifies what "comparable" assets are for this purpose. At the time of selection of the assets: (1) the most relevant factors determining the expected performance of the assets are similar; and (2) as a result of such similarity, it could reasonably have been expected, on the basis of indications such as past performance or applicable models, that their performance would not be significantly different.

Transparency

The originator, sponsor and SSPE of a securitisation must designate amongst themselves one entity to make available to a securitisation repository (or, until such time as a securitisation repository is established, via an appropriately structured website) the following information:

- all underlying documentation relevant to the securitisation;

- the prospectus for the transaction or, where no prospectus has been prepared, a transaction summary;
- in the case of an STS securitisation, the STS notification;
- information on the underlying exposures on a quarterly (or, in the case of ABCP, monthly) basis;
- quarterly investor reports (including all material relevant data on the credit quality and performance of the underlying exposures, waterfall and counterparty replacement triggers, cashflows and liabilities of the transaction, and information on the risk retention holding); and
- any information that the originator is required to make public by Article 17 of Regulation (EU) No. 596/2014 ("**MAR**"), or alternatively all significant events including, for example, a material breach of obligations or change in the structural features of the transaction.

Specific timing requirements apply for each item (for example, the documentation, prospectus (or transaction summary) and STS notification must be available before pricing). In practice, for private transactions, "pricing" may generally be interpreted as the signing date of the transaction.

Two helpful derogations exist. For private transactions (where no prospectus is required to be drawn up) the specified information must be made available to holders of the securitisation positions, to the competent authorities and, upon request, to potential investors, but need not be made available to a securitisation repository or on a website. For ABCP securitisations, information in relation to the underlying exposures must be made available in aggregate form to holders of securitisation positions and, upon request, to potential investors, with loan-level data being made available to the sponsor and, upon request, to competent authorities. The position in relation to disclosure to competent authorities is still developing. In the UK, the FCA and PRA have published a statement that requires the submission of a short form notification to the relevant regulator before pricing, but has not required the other information to be provided unless requested. It is to be hoped that other European regulators will take a similarly pragmatic approach for private transactions.

Regulatory and implementing technical standards have been developed to support the new transparency and disclosure requirements, but have not been finally published. The current drafts provide for a toolkit of "investor report" templates and "underlying exposure" templates, in each case by transaction category and asset class. The loan-by-loan disclosure templates are very similar to existing data templates known to the industry (including as used by the European Central Bank for its liquidity programmes), but ESMA has sought to build on market experience by adjusting certain data fields, and also to ensure that the templates provide all of the information required for institutions to adopt the SEC-IRBA approach to calculating the own funds requirement for securitisation positions.

STS

The Securitisation Regulation sets out the criteria for "simple", "transparent" and "standardised" securitisations which are required to be fulfilled in order to satisfy the STS classification. There are separate requirements for ABCP and non-ABCP STS securitisations.

As clearly emphasised in recital 16 of the SR, "although securitisations that are simple, transparent and standardised have in the past performed well, the satisfaction of any STS requirements does not mean that the securitisation position is free of risks, nor does it indicate anything about the credit quality underlying the securitisation. Instead, it should be understood to indicate that a prudent and diligent investor will be able to analyse the risks involved in the securitisation". **In other words, labelling a securitisation as STS does not mean that the securitisation is without risks: it means that such securitisation meets certain minimum standards (described in more detail below) and that a prudent and diligent adviser should be able to analyse the risks involved.**

The following should be kept in mind:

- A securitisation does not have to comply with the STS criteria in order for investors to invest. However it will affect the capital charge levied on a securitisation in the hands of regulated banks and insurance undertakings, which may mean that there is reduced appetite for non-STS securitisations.
- The STS label is not available to non-EU originators, sponsors and SSPEs. The Commission is due to report on the functioning of the Securitisation Regulation three years from its date of application, assessing whether an equivalence regime could be introduced for third country originators, sponsors and SSPEs in STS securitisations, taking into consideration international developments in securitisation. The UK is expected to retain an STS regime following Brexit, but the two regimes may not dovetail: a UK STS transaction may not be STS in the hands of an EU bank, and vice versa.
- The SR contemplates that pre-2019 securitisations may be STS. In respect of securitisations the securities of which were issued before 1 January 2019 (other than securitisation positions relating to an ABCP transaction or an ABCP programme), originators, sponsors and SSPEs may use the designation "STS" if they can comply with the relevant conditions. The SR provides for certain derogations from the STS provisions (primarily timing-related) to allow transactions concluded prior to 1 January 2019 to qualify. However, given the very detailed and specific requirements for a transaction to qualify, it may be difficult for a pre-2019 transaction to meet the criteria.

On 12 December 2018 the EBA published (i) a final report on the guidelines on the STS criteria for non-ABCP securitisation (the "**Non-ABCP STS Guidelines**") and (ii) a final report on the guidelines for STS criteria for ABCP securitisation (the "**ABCP STS Guidelines**").

Simplicity criteria

Sale or assignment: The transfer of assets must be made by a sale or assignment "or transfer with the same legal effect". The EBA has confirmed there is no comprehensive list or examples of methods that should or should not be considered to have "the same legal effect" as a true sale or assignment in a particular jurisdiction. It may be possible to conclude, depending on the jurisdiction, that a transfer by way of a trust or by way of security would meet that criteria.

Recital 24 of the SR makes clear that synthetic securitisation structures involve additional counterparty credit risk and potential complexity related in particular to the content of the derivative contract and, for these reasons, the STS criteria do not presently allow synthetic securitisation.

However, in respect of balance sheet synthetic securitisations, the EBA is to determine a set of STS criteria, with a view to promoting the financing of the real economy and in particular of SMEs. The Commission must then draft a report and, if appropriate, adopt a legislative proposal in order to extend the STS framework to such securitisations.

The transfer of the title in the assets to the SSPE shall not be subject to severe clawback provisions in the event of the seller's insolvency. Severe clawback provisions are specified as: (i) provisions which allow the liquidator of the seller to invalidate the sale of the underlying exposures solely on the basis that it was concluded within a certain period before the declaration of the seller's insolvency; and (ii) provisions where the SSPE can only prevent the invalidation if it can prove that it was not aware of the insolvency of the seller at the time of sale. Clawback provisions in national insolvency laws that allow the liquidator or a court to invalidate the sale of underlying exposures in the case of fraudulent transfers, unfair prejudice to creditors or transfers intended to improperly favour particular creditors over others do not constitute severe clawback provisions. The Non-ABCP STS Guidelines confirmed that "severe clawback provisions" should not include statutory provisions granting rights to a liquidator or a court to invalidate the transfer of title with the aim of preventing or combating fraud. The Non-ABCP STS Guidelines also specify that a legal opinion provided by qualified external legal counsel must be obtained, which contains a confirmation of the true sale, confirmation of enforceability of the true sale and assessment of clawback risks and re-characterisation risks.

Representations and warranties: The originator, sponsor or original lender must provide representations and warranties that, to the best of their knowledge, the underlying assets are not encumbered or otherwise in a condition likely to adversely affect enforceability of the sale or assignment.

No active management: There must be pre-determined eligibility criteria in place that do not permit active portfolio management on a discretionary basis. On the basis of this criterion, managed CLOs would not qualify as STS. The SR provides usefully that substitution of exposures that are in breach of representations and warranties should, in principle, not be considered active portfolio management. The Non-ABCP STS Guidelines confirmed that replenishment of underlying exposures or use of "ramp up" shall not be considered active portfolio management. The EBA has specified that the following are considered to be active portfolio management: (i) where portfolio management makes the performance of the securitisation dependent on the performance of the underlying exposures and on the performance of the portfolio management of the securitisation, thereby preventing the investor from modelling the credit risk of the underlying exposures without considering the portfolio management strategy of the portfolio manager; or (ii) if the portfolio management is performed for speculative purposes aiming to achieve better performance, increased yield, overall financial returns or other purely financial or economic benefit.

Homogeneity and enforceability: The securitised assets must be homogeneous in terms of asset type (taking into account the specific characteristics relating to the cash flows of the asset type including their contractual, credit-risk and prepayment characteristics) so that investors would not need to analyse different credit risk profiles. In the draft RTS on homogeneity of underlying exposures in securitisation dated 31 July 2018, the EBA emphasised that the "main objective of the requirement on homogeneity is to facilitate the assessment of underlying risks for investors and hence facilitate the investor's due diligence. This should prevent structuring securitisations where the pool of exposures is composed of overly heterogeneous exposures in terms of risk profiles and cash flow characteristics, making the modelling assumptions for the investors overly complex". A pool of underlying exposures shall comprise only one asset type (eg pools of residential loans, corporate loans, business property loans, leases and credit facilities to undertakings of the same category, or pools of auto loans and leases, or pools of credit facilities to individuals for personal, family or household consumption purposes) and may not include transferrable securities. The draft RTS on homogeneity sets out that underlying exposures are deemed to be homogeneous where all of the following conditions apply:

- the underlying exposures in the pool have been underwritten according to similar underwriting standards which apply similar approaches to the assessment of credit risk associated with the underlying exposures;
- the underlying exposures in the pool are serviced according to similar servicing procedures with respect to monitoring, collection and administration of cash receivables from the underlying exposures on the asset side of the SSPE;
- the underlying exposures in the pool all fall within the same asset category;
- with the exception of the consumer loans and trade receivables asset categories, the underlying exposures are homogeneous with reference to at least one "homogeneity factor" from among those available for the respective asset category in accordance with homogeneity factors set out in the draft RTS. These include, for example, type of obligor, ranking of security, jurisdiction.

No re-securitisations: The underlying exposures may not include any securitisation position (there are no carve-outs to this criterion within the STS framework). As under the previous legislation, some ABCP structures may require careful analysis in the context of the definition of "re-securitisation". Recital 16 of the SR confirms the possibility of assignments between two SSPEs by specifying that "In an ABCP transaction, securitisation could be achieved, inter alia, through agreement on a variable purchase-price discount on the pool of underlying exposures, or the issuance of senior and junior notes by an SSPE in a co-funding structure where the senior notes are then transferred to the purchasing entities of one or more ABCP programmes. However, ABCP transactions qualifying as STS should not include any re-securitisations". The possibility of an SSPE acquiring receivables to issue notes subscribed for by another "refinancing" SSPE (without transferring the receivables so acquired to such refinancing SSPE) is important to permit refinancing structures. While further guidance on the possibility of transfers of assets between two SSPEs would be welcomed, based on guidelines published by the EBA to date, only "re-tranching" of notes issued by the "first SSPE in the chain" is prohibited.

Ordinary course origination: Assets in the securitisation must be originated in the ordinary course of the originator or original lender's business, and according to underwriting standards that are no less stringent than those applied to similar non-securitised assets.

Originator expertise: The originator or original lender must have expertise in originating exposures of a similar nature to those securitised. The Non-ABCP STS Guidelines further specify that the originator or original lender are deemed to have the required expertise if (i) the business of the entity (or consolidated group) has included originating similar exposures for at least five years or (ii) where this is not met, at least two members of the management body and senior staff have relevant professional experience in origination for at least five years.

No defaulted loans: No loans may be in default (within the meaning of Article 178(1) of the CRR, ie a defaulted debtor is a debtor who is unlikely to pay its credit obligation to the originator without recourse by the originator to actions such as enforcing security, or where one or more payments in respect of the debt has been outstanding for more than 90 days) at the time of transfer into the securitisation.

No credit-impaired obligors: At the time of transfer into the securitisation, no loans may constitute exposures to credit impaired obligors. A credit-impaired obligor is an obligor who, to the best of the knowledge of the originator or original lender: (i) has been declared insolvent within three years prior to the date of origination; (ii) is on an official registry of persons with an adverse credit history; or (iii) has a credit assessment or credit score indicating a significantly higher than average risk of default for the type of loan in the relevant jurisdiction.

One payment: At least one payment must have been made at the time the loan is transferred to the securitisation, except in the case of revolving securitisations backed by exposures payable in a single instalment or having a maturity of less than one year, including monthly payments on revolving credits.

No predominant dependence on sale of assets: The repayment of the securitisation may not depend predominantly on the sale of the assets securing the underlying exposures. As specified by the SR, this does not prevent the underlying assets being subsequently rolled over or refinanced. Recital 29 of the SR also specifically excludes commercial mortgage-backed securities ("**CMBS**") from qualifying as STS. The Non-ABCP STS Guidelines specify that this is not aimed at excluding leasing transactions and interest-only residential mortgages from STS securitisation, "provided they comply with the guidance provided and all other applicable STS requirements". The guidance then specifies

that transactions where all of the following conditions apply would not be considered to be predominantly dependent on the sale of assets: (i) the contractually agreed outstanding principal balance, at contract maturity of the underlying exposures that depend on the sale of the assets securing those underlying exposures to repay the principal balance, corresponds to no more than 50% of the total initial exposure value of all securitisation positions of the securitisation; (ii) the maturities of the underlying exposures referred to in point (i) are not subject to material concentrations and are sufficiently distributed across the life of the transaction; and (iii) the aggregate exposure value of all the underlying exposures referred to in point (i) to a single obligor does not exceed 2% of the aggregate exposure value of all underlying exposures in the securitisation.

Standardisation criteria

Risk retention: The risk retention rules in the SR must be complied with.

Hedging: The interest rate and currency risks in the securitisation must be mitigated (via derivatives or otherwise) and the mitigation measures disclosed. Only derivatives to hedge interest rate and currency risk are permitted and such derivatives must be documented and underwritten according to common international standards.

Standard reference rates: Any referenced interest payments under the securitisation assets and liabilities must be based on generally used market interest rates, or generally used sectoral rates reflective of the cost of funds, and shall not reference complex formulae or derivatives.

No cash trap in case of acceleration/ enforcement notice: Where an enforcement or acceleration notice has been delivered, principal receipts must be distributed in order of seniority, with no substantial amount of cash trapped in the securitisation on each payment date.

Transactions featuring non-sequential priority of payments: Transactions which feature non-sequential priorities of payment must include triggers relating to the performance of the underlying exposures which result in the priority of payments reverting to sequential payments in order of seniority. Such performance-related triggers must include at least the deterioration in the credit quality of the underlying exposures below a predetermined threshold.

Early amortisation provisions or triggers for termination of the revolving period: If there is a revolving period, the transaction must provide for early amortisation triggers. These should include, at a minimum: (i) a deterioration in the credit quality of the underlying exposures below a pre-determined threshold; (ii) the occurrence of an insolvency-related event with regard to the originator or the servicer; (iii) the value of the underlying exposures falling below a pre-determined threshold and (iv) a failure to generate sufficient new underlying exposures that meet the predetermined credit quality.

Servicer expertise: The servicer must have expertise in servicing exposures of a similar nature to those securitised, and have well-documented and adequate policies, procedures and risk-management controls relating to the servicing of exposures.

Documentation: The documentation must:

- clearly specify the obligations and responsibilities of the transaction parties;
- provide remedies and actions relating to delinquency and default of debtors, debt restructuring, debt forgiveness, forbearance, payment holidays, losses, charge offs, recoveries and other asset performance remedies; and
- facilitate the timely resolution of conflicts between different classes of investors.

Other provisions: Voting rights must be clearly defined and allocated to bondholders, and the responsibilities of the trustee and other entities with fiduciary duties to investors must be clearly identified.

Transparency criteria

Historical data provision: Prior to investment, the originator, sponsor and issuer must provide investors with access to data on static and dynamic historical default and loss performance, such as delinquency and default data for substantially similar assets. This data must cover at least five years. The Non-ABCP STS Guidelines explains that new asset classes entering the securitisation market in respect of which a sufficient track record of performance has not yet been built up may not be considered transparent as they cannot ensure that investors have the appropriate tools and knowledge to carry out proper risk analysis. However, importantly, the guidelines also provide that where the seller cannot provide such data, then external data that are publicly available or are provided by a third party, such as a rating agency or another market participant ("proxy data"), may be used.

External verification: There must be external verification of a sample of the underlying assets by an appropriate and independent party, including verification that the data disclosed in respect of the underlying exposures is accurate. The Non-ABCP STS Guidelines further specify that the verification on the representative sample should apply a confidence level of at least 95% and should include (i) verification of the compliance of the underlying exposures in the provisional portfolio with the eligibility criteria that are able to be tested prior to issuance and (ii) verification of the fact that the data disclosed to investors in any formal offering document is accurate. The guidelines also specifies that confirmation that the verification has occurred and no significant adverse findings have been found should be disclosed.

Cash flow model: The originator or the sponsor must, before the pricing of the securitisation, make available to potential investors a liability cash flow model which precisely represents the contractual relationship between the underlying exposures and the payments flowing between the originator, sponsor, investors, other third parties and the SSPE, and shall, after pricing, make that model available to investors on an ongoing basis and to potential investors upon request.

Transparency: The originator, sponsor and issuer must comply with the other specific transparency requirements of the SR. In the case of a securitisation where the underlying exposures are residential loans or auto loans or leases, the originator and sponsor shall publish the available information related to the environmental performance of the assets financed by such residential loans or auto loans or leases. This echoes the ESG (Environmental, Social, Governance) Label, which is intended to reassure investors that their assets are invested in an investment fund which incorporates ESG considerations throughout its investment process.

ABCP securitisations

Additional provisions for ABCP securitisations are set out separately at both (i) the transaction level (ie for a particular transaction financed through ABCP) and (ii) the programme level (the ABCP refinancing several transactions through conduits).

Transaction level criteria

The following STS criteria apply the same way (or largely the same way): sale or assignment, representations and warranties, no active management, no re-securitisation, ordinary course origination, no defaulted exposures, no credit-impaired obligors, one payment, no proceeds of sale, hedging, standard reference rates, historical provisions, transparency (noting that the data must cover a period no shorter than five years, except for data relating to trade receivables and other short-term receivables, for which the historical period must be no shorter than three years).

As regards homogeneity, the pool of underlying exposures must have a remaining weighted average life of not more than one year, and none of the underlying exposures may have a residual maturity of more than three years. However, pools of auto loans, auto leases and equipment lease transactions are permitted to have a remaining weighted average life of not more than three and a half years, provided that none of the underlying exposures have a residual maturity of more than six years (this was heavily negotiated and is the result of a compromise). The underlying exposures may not include loans secured by residential or commercial mortgages or fully guaranteed residential loans.

Following a situation of a seller's default or an acceleration event, in an ABCP transaction, the cash amount kept in the SSPE should only be what is necessary to ensure the operational functioning of the SSPE or the orderly repayment of investors. Principal receipts from the exposures should be passed to investors, and no provisions shall require automatic liquidation of the underlying exposures at market value.

Where an ABCP transaction is a revolving securitisation, the transaction documentation should include triggers for termination of the revolving period, including at least a deterioration in the credit quality of the underlying exposures to or below a predetermined threshold; and the occurrence of an insolvency related event with regard to the seller or servicer.

Programme level criteria

For ABCP issued at the programme level to be eligible, the programme must be eligible, as must every transaction included in the programme. This is likely to be very burdensome in practice for conduits that refinance trade receivables securitisation programmes. However, the SR provides that a maximum of 5% of the aggregate amount of the exposures underlying the ABCP transactions and which are funded by the ABCP programme may temporarily, and for a period of no more than three months from the first occurrence of non-compliance, be non-compliant with the STS requirements without affecting the STS status of the ABCP

programme. A sample of the underlying exposures belonging to all transactions funded by the ABCP programme must be regularly subject to external verification of compliance by an appropriate and independent party. The percentage of the aggregate amount of the exposures of the sample that are non-compliant must be disclosed to investors in a formal offering document.

The sponsor of the ABCP programme must be a credit institution supervised in accordance with the CRR. The sponsor must support all securitisation positions at an ABCP programme level by covering all liquidity and credit risks, and any material dilution risks of the securitised exposures, as well as any other transaction- and programme-level costs if necessary to guarantee to the investor the full payment of any supported amount under the ABCP. The sponsor must demonstrate to its competent authority that its sponsor role does not endanger its solvency and liquidity, even in an extreme stress situation in the market.

The seller, at the level of a transaction, or the sponsor, at the level of the ABCP programme, must satisfy the risk retention requirement (auditors may be reluctant to conclude that programmes can be off balance sheet for the seller in circumstances where seller retention applies).

The remaining weighted average life of the underlying exposures of an ABCP programme may not be more than two years.

The securities issued by an ABCP programme may not include call options, extension clauses or other clauses that have an effect on the final maturity of the debt issued, where such options or clauses may be exercised at the discretion of the seller, sponsor or SSPE. The EBA, in the ABCP STS Guidelines, has explained that the objective of this criterion is to ensure that investors do not become exposed to higher risks (eg refinancing risk, liquidity risk) at the discretion of the seller, sponsor or SSPE, as this would complicate their due diligence and risk analysis. The guidelines, however, do not provide any further clarification or guidance on this criterion.

As for ABCP transactions, ABCP programmes must not contain any re-securitisation. In addition, the credit enhancement must not establish a second layering of tranching at the programme level.

As for ABCP transactions, interest rate and currency risks arising at ABCP programme level must also be mitigated.

Notification and disclosure

Originators and sponsors must jointly notify ESMA where a securitisation meets the STS requirements described above. Originators and sponsors of an STS securitisation must also inform their competent authorities of the STS notification, and designate amongst themselves one entity to be the first contact point for investors and competent authorities. In the case of an ABCP programme, the sponsor alone is responsible for the notification of the programme and, within that programme, of the ABCP transactions complying with STS requirements.

The STS notification must include an explanation by the originator and sponsor of how each of the STS criteria has been complied with. The originator and sponsor must immediately notify ESMA and inform their competent authority when a securitisation no longer meets the requirements.

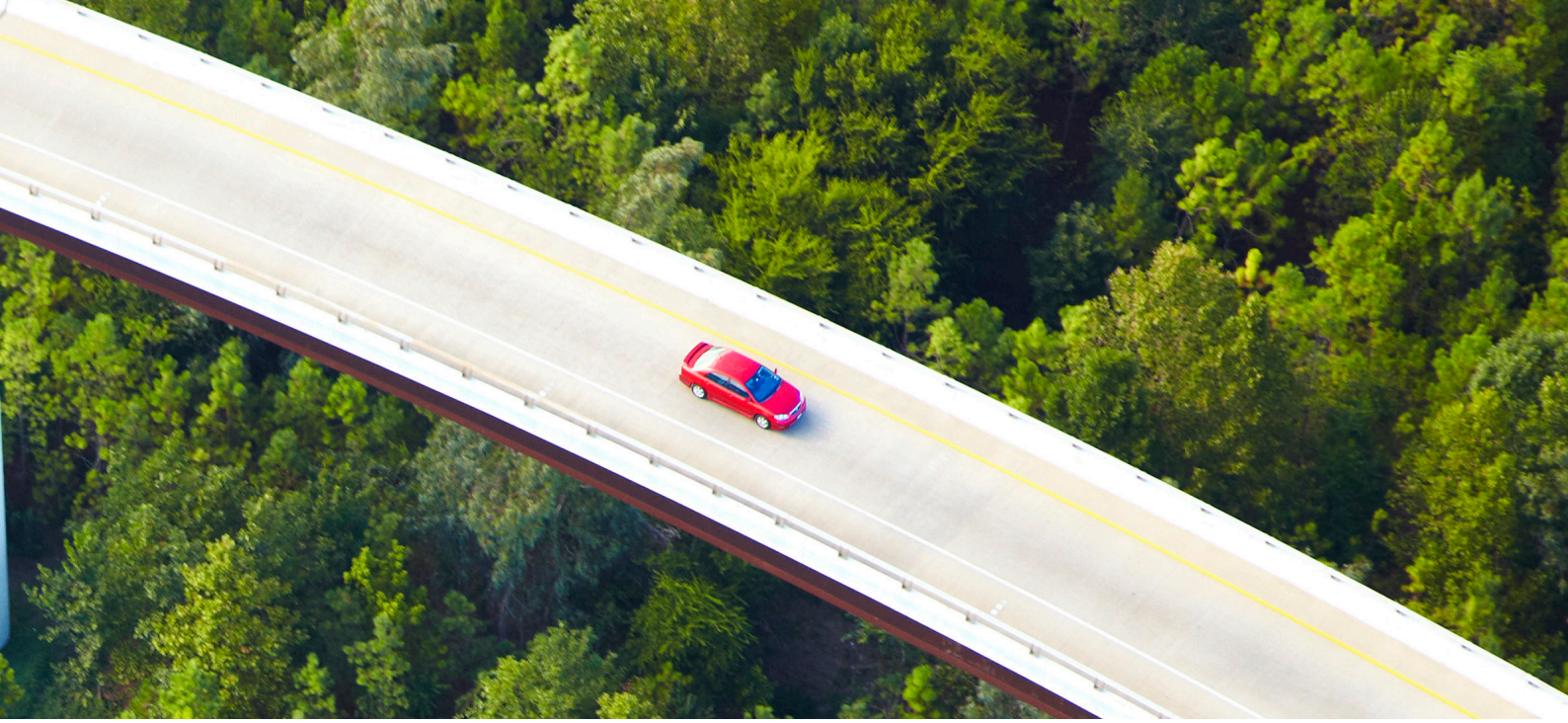
The originator, sponsor or SSPE may use the service of a third party verifying STS compliance. In that case, the STS notification must include a statement that compliance with the STS criteria was confirmed by that authorised third party.

ESMA is required to publish the STS notification on its official website. However, the SR emphasises that, "the inclusion of a securitisation issuance in ESMA's list of notified STS securitisations **does not imply that ESMA or other competent authorities have certified that the securitisation meets the STS requirements**. Compliance with the STS requirements remains solely the responsibility of the originators, sponsors and SSPEs".

ESMA must also maintain on its official website a list of all securitisations which the originators and sponsors have notified to ESMA as STS. ESMA must add each securitisation so notified to that list immediately and must update the list where the securitisations are no longer considered to be STS, whether following a decision of competent authorities or a notification by the originator or sponsor. However, the SR provides that "In order to avoid discouraging market participants from using that designation, competent authorities should have the ability to grant the originator, sponsor and SSPE a grace period of three months to rectify any erroneous use of the designation that they have used in good faith. During that grace period, the securitisation in question should continue to be considered STS-compliant and should not be deleted from the list drawn up by ESMA in accordance with this Regulation."

Supervision and sanctions

Consistent with the aim of a new unified regime, the SR provides explicitly for supervision of the rules it lays down. In the case of entities which are already subject to regulatory supervision, the requirements are to be monitored by the relevant national competent authorities. In respect of originators, original lenders and SSPEs that are not otherwise subject to regulatory



supervision, and in relation to compliance by originators, sponsors and SSPEs with the STS requirements, Member States are required to designate a competent authority to supervise compliance.

There is a carve-out from supervision for entities that are only selling exposures under an ABCP programme or other securitisation transaction, and are not actively originating exposures for the primary purpose of securitising them on a regular basis. This appears to be a sensible limitation aimed at commercial businesses seeking finance through trade receivables securitisation transactions. In respect of some aspects of the legislation, the SR contemplates that the originator or sponsor of the securitisation transaction should monitor compliance.

Member States must ensure that the competent authorities are empowered to impose administrative sanctions and remedial measures for breach of the requirements in the SR. The required sanctions regime focusses particularly on compliance by originators and sponsors with the core obligations of risk retention, credit granting and transparency, and on compliance by all relevant entities with the requirements relating to STS securitisation. The sanctions which must be made available to competent authorities include the following:

1. a public statement specifying the identity of the wrongdoer and the nature of the breach;
2. a cease and desist order addressed to the wrongdoer;
3. a temporary ban preventing any manager or any other natural person held responsible for the infringement within an originator, sponsor or SSPE, from exercising management functions in such undertakings;
4. a temporary ban which may be imposed on an entity from notifying an STS securitisation (for having failed to meet the STS requirements after making a notification, or having made a misleading notification);
5. a maximum fine of at least €5,000,000 or its equivalent for natural or legal persons;
6. a maximum fine up to 10% of the total annual net turnover of a legal person; and
7. a maximum fine of at least twice the amount of the benefit derived from the infringement (where that benefit can be determined), even if the outcome of the calculation exceeds the maximum amounts in points 5 and 6.

Some comfort may be taken from the fact that the SR provides for application of the sanctions to be considered taking into account factors relating to the breach, such as its gravity and duration, and the extent to which the infringement is intentional or results from negligence.

The SR also looks at prudential supervision of the industry, asking competent authorities to monitor the specific effects that participation in the securitisation market has on the stability of a financial institution operating as original lender, originator, sponsor or investor, and take action to mitigate any material risks to the financial stability of that institution or the financial system as a whole.

Designation of a supervisory authority for those market participants who are not otherwise supervised, and implementation of the sanctions regime, are matters for each Member State to undertake. It will therefore be necessary to seek legal advice in each relevant jurisdiction in relation to that implementation.

Finally, the SR contemplates that macroprudential oversight of the EU securitisation markets should be performed by the European Systemic Risk Board, with powers to issue recommendations for remedial action in response to financial stability risks, including an explicit ability to make recommendations to modify the required level of risk retention. Any such recommendations would require a response from the Council and the European Parliament within three months, specifying the actions undertaken in response to the recommendations, and providing justifications for any inaction.

Key contacts

Joy Amis
Partner, London
T +44 20 7466 2840
joy.amis@hsf.com

John Angus
Partner, Sydney
T +61 2 9225 5346
john.angus@hsf.com

Dinesh Banani
Partner, US Securities, London
T +44 20 7466 2042
dinesh.banani@hsf.com

Vincent Danton
Of Counsel, Paris
T +33 1 53 57 74 14
vincent.danton@hsf.com

Beatriz del Rey
Of Counsel, London and Madrid
T +44 20 7466 2912
beatriz.delrey@hsf.com

Philippe Desvignes
Associate, Paris
T +33 1 53 57 69 82
philippe.desvignes@hsf.com

Matthias Gippert
Senior Associate, Berlin
T +49 30 2215 10461
matthias.gippert@hsf.com

Vincent Hatton
Partner, Paris
T +33 1 53 57 70 85
vincent.hatton@hsf.com

Vinh Huynh
Executive Counsel, Sydney
T +61 2 9225 5196
vinh.huynh@hsf.com

Jake Jackaman
Partner, London
T +44 20 7466 2883
jake.jackaman@hsf.com

Charlene Kong
Senior Associate, London
T +44 20 7466 2782
charlene.kong@hsf.com

Kai Liebrich
Partner, Frankfurt
T +49 69 2222 82541
kai.liebrich@hsf.com

Patrick Lowden
Partner, Sydney
T +61 2 9225 5647
patrick.lowden@hsf.com

Nicolas Martin
Partner, Madrid
T +34 91 423 4009
nicolas.martin@hsf.com

Gonzalo Martin de Nicolas
Partner, Madrid
T +34 91 423 4072
gonzalo.martindenicolas@hsf.com

Nick May
Partner, Finance, London
T +44 20 7466 2617
nick.may@hsf.com

Howard Murray
Partner, Tax, London
T +44 20 7466 2124
howard.murray@hsf.com

Tom O'Neill
Partner, US Securities, London
T +44 20 7466 2466
tom.o'neill@hsf.com

Michael Poulton
Partner, Finance, London
T +44 20 7466 2777
michael.poulton@hsf.com

Foucald Prache
Associate, Paris
T +33 1 53 57 76 62
foucauld.prache@hsf.com

Victoria Salisbury
Senior Associate, London
T +44 20 7466 2643
victoria.salisbury@hsf.com

Laura Sheridan Mouton
Partner, US Securities, Sydney
T +61 2 9225 5004
laura.sheridanmouton@hsf.com

Ahu Yalgin
Senior Associate, Finance and Capital Markets, London
T +44 20 7466 2688
ahu.yalgin@hsf.com

Gabrielle Wong
Partner, Finance and Capital Markets, London
T +44 20 7466 2144
gabrielle.wong@hsf.com

Notes

HERBERTSMITHFREEHILLS.COM

BANGKOK
Herbert Smith Freehills (Thailand) Ltd

BEIJING
Herbert Smith Freehills LLP
Beijing Representative Office (UK)

BELFAST
Herbert Smith Freehills LLP

BERLIN
Herbert Smith Freehills Germany LLP

BRISBANE
Herbert Smith Freehills

BRUSSELS
Herbert Smith Freehills LLP

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Herbert Smith Freehills LLP

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FRANKFURT
Herbert Smith Freehills Germany LLP

HONG KONG
Herbert Smith Freehills

JAKARTA
Hiswara Bunjamin and Tandjung
Herbert Smith Freehills LLP associated firm

JOHANNESBURG
Herbert Smith Freehills South Africa LLP

KUALA LUMPUR
Herbert Smith Freehills LLP
LLP0010119-FGN

LONDON
Herbert Smith Freehills LLP

MADRID
Herbert Smith Freehills Spain LLP

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PERTH
Herbert Smith Freehills

RIYADH
The Law Office of Mohammed Altammami
Herbert Smith Freehills LLP associated firm

SEOUL
Herbert Smith Freehills
Foreign Legal Consultant Office

SHANGHAI
Herbert Smith Freehills LLP
Shanghai Representative Office (UK)

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