Clients&FriendsMemo

# ECON Agrees Compromise Amendments to STS/Risk Retention

**8 December 2016**

## Introduction

The European Parliament's Committee on Economic and Monetary Affairs ("**ECON**") has today agreed compromise amendments (the "**Compromise Amendments**") to the proposed EU regulation intended to lay down common rules on securitisation and create a European framework for "simple, transparent and standardised" ("**STS**") securitisation (the "**Regulation**")[1].

## Overview

Some of the main proposals have already been flagged in previous drafts of ECON's amendments, but many have been subject to further change. Notably, there are proposals to increase the minimum retention level for most forms of risk retention, with the possibility of further increases in due course of up to an overall cap of 20 per cent. There are also important restrictions on the identity of the participants in the securitisation market, with investors being limited to specified regulated EU institutional investors (or equivalent non-EU investors), and at least one of the originator, sponsor or original lender being a specified "regulated entity". Other proposals include investor disclosure provisions and the establishment of registered securitisation repositories to which information regarding securitisations must be provided.

**It is important to note that the ECON Compromise Amendments are not the final stage in the legislative process and, as such, do not constitute the wording of the final Regulation (please see "Next steps in the legislative process" below).**

[1] 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.

**Legislative Background**

The original proposal was published on 30 September 2015 by the European Commission (the "**Commission Proposal**"), together with a proposal for amendments to the Capital Requirements Regulation[2] designed to reduce the regulatory capital requirements for exposures to STS securitisations. The Presidency of the European Council published its "Third Compromise Proposal" on 30 November 2015, which the Council confirmed in early December 2015 is the Council's agreed negotiating position (as discussed in our Clients and Friends Memorandum dated 17 December 2015)[3].

The European Parliament has been considering the proposed Regulation for much of 2016. Paul Tang MEP, the ECON Rapporteur for this legislative proposal, has been preparing his report containing the European Parliament's proposed amendments to the Commission Proposal.

Following discussions between representatives of the different political groups in ECON, the Compromise Amendments were prepared in an attempt to reconcile the differing positions. ECON adopted its report, in the form of amendments to the Commission Proposal and an accompanying legislative resolution, in its vote on 8 December 2016.

**The Compromise Amendments**

The Compromise Amendments, to a large extent reflect those contained in Paul Tang's "Draft Report" dated 6 June 2016, which we discussed in our Clients and Friends Memorandum dated 10 June 2016[4].

**The European Parliament has a different focus regarding the purpose of the Proposed Regulation**

In its original proposal, the Commission noted that a framework for EU securitisation, including the development of an STS securitisation market, would promote the integration of EU financial markets and so form a significant part of the EU's projected Capital Markets Union. The economic value of securitisation in diversifying funding sources and unlocking capital was highlighted by the Commission.

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[2] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

[3] http://www.cadwalader.com/resources/clients-friends-memos/update-on-the-eus-proposed-regulation-onsecuritisation-and-its-potential-impact-on-us-market-participants

[4] http://www.cadwalader.com/resources/clients-friends-memos/european-parliament-rapporteur-publishes-draft-amendments-to-the-proposed-eu-securitisation-regulation

The Council also recognised that a framework for securitisation is a major building block of developing a Capital Markets Union and would help provide an additional source of finance, particularly for small and medium-sized enterprises.

However, many Members of the European Parliament seem to be much more sceptical about the benefits of securitisation, and this scepticism has formed the background to many of ECON's proposed amendments. This difference in approach can be seen clearly in ECON's proposed amendment to the Recitals to the Regulation, which it considers should recognise the "risks of increased interconnectedness and of excessive leverage that securitisation raises", should emphasise the importance of the regulation of financial institutions' participation in the market, and should give a role to the European System Risk Board ("**ESRB**") in the "macro-prudential oversight" of the market.

**Risk Retention**

Probably the most significant of the Compromise Amendments, and that which has caused greatest concern in the industry, is the amended Article 4, concerning minimum risk retention levels. It is proposed that minimum risk retention levels will increase from the current 5 per cent. to 10 per cent. for each risk retention option, save for: (i) the first loss tranche approach, where the minimum level remains at 5 per cent.; and (ii) the retention of a first loss exposure of every securitised exposure, where the minimum level will be 7.5 per cent. of every securitised exposure in the securitisation (although it is then stated draft that Regulatory Technical Standards ("**RTS**") (please see below) *"will determine the appropriate minimum retention of a first loss exposure of every securitised asset as a value between 5% and 10%."* ).

However, this 10 per cent., or 5 per cent. (or 7.5 per cent), level is merely set as a floor, and provision is made for the European Banking Authority ("**EBA**") and the ESRB to take a "reasoned decision" on required retention rates of up to 20 per cent. in light of market circumstances under a mandate given to them in a new Article 16a.

Article 4(6) provides that the EBA (in cooperation with the European Securities and Market Authority ("**ESMA**") and the European Insurance and Occupational Pensions Authority ("**EIOPA**")) shall develop draft RTS "to amend the level of risk retention according to Article 16a". These RTS will specify the minimum retention rate for the first loss exposure approach (i.e. that described in the Regulation as both being a minimum of 7.5 per cent and "*between 5% and 10%*", as noted above). On the basis of these RTS, competent authorities (i.e. national regulators) will be required to maintain a table of the risk retention rates for different types of securitisation. The EBA will ensure consistency in the implementation of the RTS by the competent authorities. The EBA shall submit these draft RTS to the Commission within six months of entry into force of the Regulation.

The new Article 16a provides that the ESRB, together with the EBA, will have an oversight role for the European securitisation market. It also provides that, in order to reflect changes of market circumstances, to prevent asset bubbles from developing and to prevent the EU's securitisation market from closing down, the EBA, in close cooperation with ESRB, shall develop draft RTS in order to specify the retention rate within a range of 5 per cent. to 20 per cent. It shall then develop revised RTS on this subject every two years thereafter. These RTS will specify whether the required retention rates shall be brought up to the maximum of 20% or whether they should be adjusted downwards.

However, these RTS will not be prepared straight away. In one part of Article 16a it says that they will be prepared within six months after the publication of the European Commission's report on the effects of the Regulation, which is to be prepared two years after the date of entry into force of the Regulation. In another part of Article 16a, it says that the "draft RTS shall be developed within two years after [entry into force] of this Regulation or, as the case may be, two years after the most recent draft RTS based on this paragraph."

Although the wording of these two articles is not entirely clear, it appears that the effect of these proposals may be that risk retention rates could default to 20 per cent. unless the EBA specifies otherwise in RTS to be prepared pursuant to the Regulation.

The possibility of having different risk retention rates for different types of securitisation will introduce further significant complexities in the regulation of securitisation in the EU. The idea of having a series of different risk retention levels, which could be subject to further change every two years, not only risks causing distortions to the European securitisation market, but could, in combination with ECON's other proposed amendments, hamper the market.

**The Originator, Sponsor or Original Lender needs to be a Regulated Entity**

Article 2a in the Compromise Amendments provides that at least one of the originator, sponsor or original lender in a securitisation will need to be a "*regulated entity*" [5].

[5] 'Regulated entity' means: a regulated entity as defined in Article 2(4) of Directive 2002/87/EC, as amended, Article 4(2) of Directive 2014/17/EU, a financial institution whose main corporate objective is to provide financial accommodations, such as loans, leases, hire-purchase arrangements or similar accommodations falling within the scope of Article 4 paragraph 1 sub 26 of Regulation (EU) No 575/2013 that conducts the lending business or financial leasing pursuant to point 2 and 3 of Annex I to Directive 2013/36/, or a multilateral development bank within the meaning of Article 117(2) of Regulation (EU) No 575/2013.

In the definition in Article 2(4) of Directive 2002/87/EC, as amended, "regulated entity" means "a credit institution, an insurance undertaking, a reinsurance undertaking, an investment firm, an asset management company or an alternative investment fund manager". The definition of "investment firm" in Directive 2002/87/EC, as amended, includes an undertaking the registered office of which is in a third country and which would require authorisation under the Markets in Financial Instruments Directive if its registered office were in the EU. Similarly, in this amended

'Regulated entity' is mainly defined by reference to the definition in the Financial Conglomerates Directive,[6] as amended, which term includes EU regulated banks, investment firms, insurance firms, and alternative investment fund managers. However, we note that it is possible that some non-EU entities may be within this definition (although it is not entirely clear whether this is the European Parliament's intention): for example, the definition of "investment firm" in the Financial Conglomerates Directive, as amended, includes an undertaking the registered office of which is in a non-EU country and which would require EU authorisation if its registered office were in the EU.

It appears, although it is not completely clear from the drafting, that the intention is that the retention holder will need to be such a regulated entity. If so, this provision could effectively exclude a wide range of institutions that fund themselves through the European securitisation market, but are not regulated.

This proposal would exclude corporate entities which are not "regulated entities" within the prescribed definitions from securitising assets. If these corporate entities are effectively prohibited from participating in the European securitisation market, this would close off an important source of finance for such entities and could increase their cost of borrowing.

There is also a risk that other jurisdictions may view this as a protectionist measure (because it has the effect of excluding non-EU entities from acting as retention holder).

**Only Regulated Institutional Investors are to be able to Invest in Securitisations**

The proposed Article 2a requires that investors in securitisations need to be "*institutional investors*" (which term refers to specific types of EU regulated entities), or need to be institutions of non-EU countries *"whose supervisory and regulatory requirements are considered equivalent"* to the requirements under the relevant EU legislation.

Although the expansion from earlier ECON draft amendments of the proposed Article 2a to allow equivalent non-EU institutions to invest is welcome, it is not clear how far this equivalence regime would extend.

If large numbers of non-EU investors, such as US and Asian investors, and potentially UK investors post-Brexit, are excluded from investing in the EU securitisation market,

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Directive, 'alternative investment fund manager' includes an undertaking the registered office of which is in a third country and which would require authorisation under the Alternative Investment Fund Managers Directive if its registered office were in the EU.

[6] Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

then this restriction on non-EU investors would limit access to capital from outside the EU. This provision could also potentially inhibit the ability of US branches of EU regulated banks from issuing securitisations in the US, if investors in such securitisations are restricted to EU institutional investors. For example, if the New York branch of an EU bank acting from outside the EU securitises a portfolio of loans in the US and wished to offer such a securitisation to US persons, it could be prohibited from doing so, if this equivalence regime for specified types of US investors had not been established and if all of the investors needed to be EU institutional investors.

This restriction would also have the effect of concentrating securitisation risk in the EU. These are some of the unintended potential consequences of this proposal, which could have serious repercussions for the industry.

**Restrictions on Entities that can be SPVs**

The Compromise Amendments provide that Securitisation Special Purpose Entities ("**SSPEs**") cannot be established in non-EU countries which: (a) are tax havens (i.e. a country that "*promotes itself as an off-shore financial centre or one in which there are no or nominal taxes*"); (b) lack effective exchange of information with foreign tax authorities; (c) lack legislative, judicial or administrative transparency; (d) have no requirement for a substantive local presence; (e) are listed as a "Non-Cooperative Country and Territory"; or (f) have not signed an agreement to share tax information. The wording of this amendment follows that set out in the proposed amendment contained in Paul Tang's June 2016 Draft Report.

**Article 4(1a) - Losses on securitised assets**

A new Article 4(1a) provides that losses on the securitised assets (measured over one year) shall not be significantly higher than the losses over the same period on "*homogenous assets*", which are randomly selected from the assets retained on the balance sheet of the originator or original lender. The underlying exposures in a pool are deemed to be homogeneous where they belong to the same asset type and where their contractual, credit risk, prepayment and other characteristics that determine the cash flows on those assets are sufficiently similar. ESMA will develop draft RTS specifying the criteria for determining which characteristics are sufficiently similar.

If this condition is not met, the national regulator shall investigate a potential adverse selection of assets by the originator, sponsor or the original lender, "at risk of a fine". The idea is that the national regulator will investigate a "cherry picking" of assets.

It is not clear that the full consequences of these proposals have been considered. There may be securitisations that do not involve the originator, sponsor or original lender maintaining comparable assets on their balance sheets. There were also proposals elsewhere in the Council's proposed version of the Regulation as regards "criteria for credit-granting" requiring exposures to be securitised using the same "sound and well-defined criteria" for credit-granting which are applied to non-

securitised exposures. Arguably, these should achieve the same objectives, without the necessity for this new provision.

**Disclosure Requirements on Investors**

The Compromise Amendments include a new Article 5(1a), which provides that a secondary market investor in a securitisation shall make information available to its competent authority, including that in respect of its beneficial owner, and that regarding the size of its investment and to which tranche of the securitisation it relates. To ensure consistency of information, ESMA shall develop draft RTS specifying the details on the way investors will have to report to their competent authorities.

The purpose of this requirement is to enhance transparency in the market so that regulators "know where the transferred risk precipitates". However, the likely effect of this new obligation is that it would deter many investors from investing in the European securitisation market.

**Securitisation Repository provisions**

There are a significant number of amendments in relation to the establishment and registration of securitisation repositories. There has been a move away from proposals in previous draft amendments in ECON for a central European Securitisation Data Repository, towards having a number of securitisation repositories registered with ESMA. The Compromise Amendments set out, in detail, the conditions and procedures for the registration of securitisation repositories (many of which are based on similar provisions in the Securities Financing Transactions Regulation[7] and the European Market Infrastructure Regulation[8]).

The originator, sponsor or SSPE will be required to make available prescribed information relating to the securitisation to the securitisation repository. The idea is that national regulators and investors will have access to significant information regarding securitisations. However, it is not entirely clear how these information requirements will interact with those set out elsewhere in EU legislation (e.g. those under MIFID 2[9]).

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[7] Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012

[8] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

[9] The regime under Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, and Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

**Ban on re-securitisation**
A new Article provides that the underlying exposures used in a securitisation will not be able to include securitisations. This ban on re-securitisations is included despite the revised Basel securitisation framework having addressed re-securitisation by requiring significantly increased risk weights.

**STS securitisations**
There are a number of proposed amendments on simple, transparent and standardised securitisations, notably, the requirement that the originator, sponsor and SSPE involved in an STS securitisation will need to be established in the EU (unless they are established in a non-EU country that the Commission has deemed equivalent – please see "STS Securitisations equivalence of third-country regimes" below).

There is a welcome new transitional provision allowing securitisations (excluding asset-backed commercial paper ("**ABCP**")), sold to investors after 1 January 2011 and before the date of entry into force of the Regulation, to be considered "STS" provided that they met, at the time of issuance, the prescribed criteria and provided that they are notified to ESMA.

**STS securitisations: role of the sponsor of an ABCP programme**
The Commission Proposal set out the requirements for ABCP programmes to be considered "STS" securitisations. The Compromise Amendments include a number of amendments to this section of the proposed Regulation including a new Article 12 regarding the type of regulated entities who can be sponsors of ABCP programmes and concerning the obligations on such sponsors. Before being able to sponsor an STS ABCP programme, an EU bank will need to demonstrate to its regulator in a stress test that its role as sponsor does not endanger its financial stability.

**STS securitisations: equivalence of third-country regimes**
A new amendment empowers the Commission to determine that the legal, supervisory and enforcement arrangements of a non-EU country are equivalent to the STS requirements laid down in the Regulation. If the non-EU country is deemed equivalent as regards these requirements, a securitisation in that country shall be deemed to have fulfilled the STS criteria.

**Fines for Non-Compliance**
The Compromise Amendments increase the level of proposed fines for infringements of the Regulation.

**Transitional provisions**
A number of RTS will need to be developed in respect of various aspects of the proposed Regulation, which will set out the detail of the regime. There will be some uncertainty as to the full scope of the regime until these RTS are published.

The proposed Regulation, as amended, does contain certain transitional provisions. The due diligence requirements laid down in current legislation will continue to apply for securitisations the securities of which have been issued from 1 January 2011 until the date of entry into force of the Regulation.

There are also transitional provisions on risk retention which cover the period until the application date of the RTS (the "**RTS Application Date**") to be adopted by the Commission pursuant to Article 4(6) of the Regulation (as noted above, the EBA is required to submit a draft of these RTS to the Commission within six months of the Regulation entering into force, and so the RTS Application Date may be many months after the Regulation enters into force). These transitional provisions allow for the risk retention provisions in the current legislation to apply to securitisations, the securities of which are issued from the date of entry into force of the Regulation until the RTS Application Date.

However, these new risk retention RTS will apply retrospectively to securitisations issued from the date the Regulation enters into force. This is potentially problematic for securitisations issued in the period from the entry into force of the Regulation until the RTS Application Date, since the new risk retention RTS will apply to such transactions as from the RTS Application Date.

**Next steps in the legislative process**

ECON's report containing the Compromise Amendments and accompanying legislative resolution will now be tabled for a vote of the full European Parliament in a plenary session, which is due to take place on 17 January 2017.

Once the European Parliament has finalised its proposals, representatives of the Parliament, the Council and the Commission will meet in in a process known as **trilogue** where a common position will be negotiated. It is possible that some of the more controversial new proposals from the Parliament could be changed during this process. After the trilogue process has been completed, a compromise text can be agreed. Once finalised, the Regulation will be published in the Official Journal of the European Union and will enter into force 20 days later.

**Conclusion**

A number of the new proposals from the European Parliament could damage the European securitisation industry if left in their current form after trilogue. Indeed, taken together, the proposed changes to the Commission Proposal are so significant that some in the industry are questioning whether the proposed Regulation would actually achieve its original intended objective of stimulating the securitisation market in the EU, or whether it would have the opposite effect.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.


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