Clients&FriendsMemo

COVID-19 Update: European Commission Proposes Changes to the European Securitisation Regulation in Response to COVID-19

29 July 2020

On 24 July 2020, the European Commission (the "**Commission**") published its proposed amendments to the current securitisation framework set out in Regulation (EU) 2017/2402 (the "**Securitisation Regulation**").[1] The proposed amendments are intended to bolster economic recovery during the COVID-19 pandemic. While the securitisation framework was not due for review until January 2022, the Commission concluded that introducing targeted amendments now could assist the economic recovery in the coming months while not substituting or diminishing the scope of the review planned in 2022.

What Do the Proposed Amendments Consist Of?

The proposed amendments, if implemented, will:

a) remove some regulatory obstacles to the securitisation of non-performing exposures ("**NPEs**"); and

b) extend the framework for simple, transparent and standardised ("**STS**") securitisations to balance-sheet synthetic securitisations.

The Commission also published on 24 July 2020 proposed amendments to Regulation 575/2013 (the "**CRR**")[2] (i) to extend the benefits of lower capital treatments to the senior tranche of balance-sheet synthetic securitisations that satisfy the STS framework; and (ii) to provide for specific capital treatment for positions in NPE securitisations.

1 https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1596024242767&uri=CELEX:52020PC0282

2 https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1596024200046&uri=CELEX:52020PC0283

I. Amendments Relating to Securitisation of NPEs

The Commission's proposals relating to the NPE securitisations are based on the European Banking Authority's (the "**EBA**") opinion on the regulatory treatment of NPE securitisations (the "**NPE Opinion**"[3]) which was published in October 2019.

The proposed amendments introduce a definition of an "NPE securitisation" which is defined as a securitisation backed by a pool of non-performing exposures that meet the conditions set out in Article 47a(3) of the CRR and the value of which makes up at least 90 per cent. of the pool's value at the time of origination.

Article 47a(3) defines non-performing exposures as any of the following:

a) an exposure in respect of which either or both of the following has taken place: (i) the institution considers that the obligor is unlikely to pay its credit obligations to the institution, the parent undertaking or any of its subsidiaries in full, without recourse by the institution to actions such as realising security or (ii) the obligor is more than 90 days past due on any material credit obligation (in the case that the exposure is not a retail exposure) or on the credit obligation relating to the particular exposure (in the case that the exposure is a retail exposure);

b) an exposure which is considered to be impaired in accordance with the applicable accounting framework;

c) an exposure which has ceased to be classified as non-performing pursuant to paragraph 6 of Article 47a(3) but which remains under probation in accordance with Article 47a(7), where additional forbearance measures are granted or where the exposure becomes more than 30 days past due;

d) an exposure in the form of a commitment that, were it drawn down or otherwise used, would likely not be paid back in full without realisation of collateral;

e) an exposure in form of a financial guarantee that is likely to be called by the guaranteed party, including where the underlying guaranteed exposure meets the criteria to be considered as nonperforming.

The proposed amendments make two changes to Article 6 of the Securitisation Regulation regarding how the EU risk retention requirement applies in respect of NPE securitisations. The first change provides that in the case of an NPE securitisation, the retention requirement may be fulfilled by the servicer as an alternative to the original lender, originator or sponsor. The second change provides that in the case of an NPE securitisation, other than where the retention is in the form of a vertical slice, the size of the required retention is to be calculated

[3] https://eba.europa.eu/eba-publishes-opinion-regulatory-treatment-non-performing-exposure-securitisations

not by reference to the nominal value of the securitised exposures but by reference to their net value, where such net value is calculated by deducting from the nominal value or outstanding value the non-refundable purchase price discount agreed at the time of origination.

Article 6(1) of the Securitisation Regulation provides that an entity shall not be considered to be an originator for the purpose of satisfying the retention requirement where it has been established or operates for the sole purpose of securitising exposures. The proposed amendments do not provide for any similar restriction in relation to a servicer that satisfies the retention requirement for an NPE securitisation.

The proposed amendments also make a change to Article 9 of the Securitisation Regulation which imposes requirements in relation to how the credits that comprise underlying assets of securitisations were granted. Under Article 9(1), originators, sponsors and original lenders are required to apply to exposures to be securitised the same sound and well-defined criteria for credit-granting as they apply to non-securitised exposures. Under Article 9(3), an originator that acquired from a third party exposures that it then securitises is required to verify that the entity that originated the exposures fulfilled the requirements in Article 9(1).

The NPE Opinion noted that the requirements of Article 9 are challenging for NPE securitisations as it cannot be said that sound and well-defined credit granting criteria were applied where NPEs are involved without taking into account the specific circumstances of the purchase of the assets and the type of securitisation.

The proposed amendments add a sentence to Article 9(1) to provide that the requirement set out therein does not apply to underlying exposures that are non-performing exposures (as defined in the CRR) at the time the originator purchased them from the relevant third party. The wording of the addition means that it applies only to securitisations of third party-originated assets. The addition does not appear to apply where an originator securitises assets which it originated itself.

Those amendments would be welcomed by participants in the NPE market and should facilitate the removal of NPEs from the balance sheet of European credit institutions, ultimately resulting in better funding capabilities of new assets.

II. Extending the STS Framework to Balance-Sheet Synthetic Securitisations

Currently, securitisation techniques that use financial guarantees, credit default swaps or credit-linked notes to transfer the risks of exposures that remain on the balance sheet of the originating institution (a form of synthetic securitisation referred to as balance-sheet synthetic securitisation) are out of the scope of the STS framework under the Securitisation Regulation.

The proposed amendments extending the STS framework to balance-sheet synthetic securitisations are based on the report prepared by the EBA (the "**STS Synthetics Report**"[4]) published earlier this year. The Commission expects that extending the STS label to balance-sheet synthetic securitisations and improving capital treatment (recognising the higher quality of STS securitisation structures) would further incentivise banks to use this type of securitisation, thereby releasing additional capital to lend to enterprises and households. Investors would also benefit from more simplicity, standardisation and transparency when investing in this kind of securitisation.

This note highlights the differences and similarities between certain criteria for synthetic STS securitisations and those applicable to non-synthetic STS securitisations and provides some observations about the ease of compliance with such requirements.

A. Simplicity Criteria (Article 26b)

Article 26b(1)-(5): Balance-sheet synthetic securitisation; credit risk mitigation

The originator must be an entity that is authorised or licenced in the European Union ("**EU**"). The underlying exposures have to be originated as part of the core business activity of the originator. At the closing date, the underlying exposures are be held on the balance sheet of the originator or of an entity of the same group of which the originator belongs. The originator is not permitted to "double hedge" the credit risk of the underlying exposures of the transaction.

*This set of conditions imposes a geographical requirement: the originator must be established in the EU; and also aims to exclude any element of "arbitrage" from the STS label. Post-Lehman, the European regulators' views have been that only balance-sheet synthetic deals, done to achieve better capital treatment, are desirable, as they permit credit institutions to increase their lending to businesses, especially small and medium-sized enterprises ("**SMEs**"). This has been well-appreciated by the industry, therefore this requirement should not impact the way most synthetic capital relief trades ("**CRT**") are already structured.*

Article 26b(6): Representations and warranties

The originator has to represent as to (i) good title and the accounting treatment of the exposure; (ii) compliance with eligibility criteria; (iii) validity and enforceability of the underlying obligation; (iv) underwriting standards; (v) lack of underlying defaults; (vi) correctness of information; and (vii) absence of amendments to the underlying obligation that could affect the enforceability or collectability.

[4] https://eba.europa.eu/eba-proposes-framework-sts-synthetic-securitisation

Given the significant level of due diligence that investors in CRT deals undertake, and the corresponding effort on the part of the originator to construct a robust and compliant portfolio, those representations are generally in line with the existing market.

Article 26b(7): Eligibility criteria; no active portfolio management

This is a requirement for predetermined and clear eligibility criteria for the pool of underlying assets. After the closing date, the securitisation should not be characterised by an active portfolio management on a discretionary basis. There is permission for (A) substitution of exposures that are in breach of representations; and (B) the addition of exposures that meet clearly defined replenishment conditions during the replenishment period.

The eligibility of assets included in the original portfolio and the restrictions on replenishments are highly negotiated in each CRT deal. The mechanism for replenishments usually involves the concept of permitted replacements of "like-for like obligations" that prescribes strict conditions for topping up of the portfolio. Therefore, we anticipate that most CRT deals would be compliant with this requirement.

Article 26(b)(8) and (9): Homogeneity, enforceable obligations, full recourse to obligor, periodic payment stream; the underlying exposures should not include transferable securities; the underlying exposures should not include any securitisation position

These requirements are similar to the requirements applicable to non-synthetic STS securitisations.

Article 26b(10): Underwriting standards

The underwriting standards pursuant to which the underlying exposures are originated (and any material changes) should be fully disclosed to investors without undue delay. The underlying exposures have to be underwritten with full recourse to an obligor that is not a securitisation special purpose entity ("**SSPE**"). Further, there is a requirement that no third party was involved in the credit or underwriting decisions relating to the underlying exposures.

Given that the investor in CRT deals is "buying" the underwriting and credit collections standards of the credit institution, those standards are usually subject to robust scrutiny at the diligence stage of the deal. The disclosure of material changes may not be a requirement in some existing CRTs, so careful drafting would be required to ensure that the originating credit institution retains control of both (i) the decision as to the materiality of any such changes, as well as (ii) any confidentiality concerns around such disclosures.

Article 26b(10)-(12): Self-certified residential loans should not be included; borrower's creditworthiness; originator's expertise; no defaulted exposures or exposures subject to outstanding disputes; at least one payment made

These requirements are similar to the requirements applicable to non-synthetic STS securitisations.

B. Standardisation Criteria (Article 26c)

Article 26c(1): Risk retention requirements

This criterion is similar to non-synthetic STS securitisations, albeit the methods to achieve risk retention will differ in synthetic deals as the originator will not buy the notes the SPPE issues but will agree to a synthetic retention of a 5 per cent. tranche of the risk.

Article 26c(2): Appropriate mitigation of interest rate and currency risks

The protection buyer should bear no currency risk in relation to the credit protection it receives.

Existing CRTs with multiple currency already contain mechanisms to convert such currency into the agreed transaction currency, usually at a spot rate determined by the originator bank.

Article 26c(3): Referenced interest payments

This condition is similar to non-synthetic STS securitisations.

Article 26c(4) and (5): Requirements after enforcement/acceleration notice

Following the occurrence of an enforcement /acceleration event, the investor has to be able to take enforcement action, terminate the credit protection or do both.

Where an SSPE is used within a synthetic securitisation, following an enforcement / acceleration notice, no amount of cash should be trapped in the SSPE beyond what is necessary to ensure the operational functioning of the SSPE or the orderly repayment of investors in accordance with the contractual terms of the securitisation.

This requirement is for the benefit of protection buyers in case adverse circumstances affect the SSPE or, where applicable, the collateral (such as insolvency of SSPE or inaccessibility of collateral). Immediate initiation of enforcement and applying sequential amortisation to all tranches of the synthetic securitisation is in line with most existing CRT deals.

Article 26c(5): Allocation of losses and amortisation of tranches

The allocation of losses to investors in a synthetic STS securitisation should always proceed in order of seniority of tranches, from the most junior tranche to the most senior tranche:

- Sequential amortisation shall be applied to all tranches to determine the outstanding amount of the tranches at each payment date, starting from the most senior tranche.

- Transactions that feature non-sequential amortisation shall have triggers for the performance of the underlying exposures changing the amortisation to sequential in order of seniority. Such performance-related triggers shall include the deterioration in the credit quality of the underlying exposures below a pre-determined threshold.

- As tranches amortise, an amount of the collateral equal to the amount of the amortisation of those tranches shall be returned to the investors, provided the investors have collateralised those tranches.

- Where a credit event has occurred in relation to underlying exposures and the debt workout process for those exposures has not been completed, the amount of credit protection remaining at any payment date shall be at least equivalent to the outstanding notional amount of those underlying exposures, minus the amount of any interim payment made in relation to those underlying exposures.

The amortisation sequence in synthetic deals has always been important for regulators. The concern is that pro rata amortisation, when coupled with back-loaded losses, may undermine the ability of the originating bank to achieve effective protection: the originator may be obtaining a level of credit protection that, towards the end of the transaction, gets materially lower than the one it could rely on when a sequential amortisation scheme is adopted. Therefore, pro rata amortisation are allowed only under limited circumstances, i.e. if it is subject to specific contractual triggers that require a switch to sequential amortisation.

Article 26c(6) : Early amortisation provisions

The transaction documents should contain triggers for termination of the revolving period (where the securitisation is a revolving securitisation), or early amortisation provisions (where an SSPE is used within a synthetic securitisation to issue notes placed with investors), including at least (i) deterioration in the credit quality of the underlying exposures to or below a predetermined threshold; (ii) losses rise above a predetermined threshold, or losses over a predefined period rise above a predetermined threshold; and (iii) failure to generate sufficient new underlying exposures that meet the predetermined credit quality.

These features are investor-friendly and do not necessarily feature in all CRTs, but should not present an issue for most deals.

Article 26c(7): Transaction documentation

Compared with non-synthetic STS securitisations, the modified requirements for STS synthetic securitisations include documenting (i) the role of a verification agent; (ii) removal of other transaction parties (including the servicer and the verification agent) in the event of default or insolvency of either of those service providers, in a manner that does not result in the termination of the provisions of those services; (iii) as well as requirements for fuller disclosure of servicing standards and procedures.

Given the moral hazard (where the lender of record declares credit events and calculates losses and recoveries), most CRTs already use a verification agent, usually an accountancy firm.

Article 26(c)(8) and (10): Servicer's expertise; timely resolution of conflict between investors

These requirements are similar to the requirements for non-synthetic STS securitisations.

Article 26c(9): Reference register

The underlying exposures should be identified at all times via a reference register, that should clearly identify, at all times, the reference obligors, the reference obligations, the outstanding notional amount and the protected notional amount for each underlying exposure.

This feature is already present in most CRT, as an established method to ensure legal certainty about the protected assets; with a requirement for regular updating and reporting of the register.

C. Transparency Criteria (Article 26d)

Article 26d(1): Data on historical default and loss performance

This criterion is similar to non-synthetic STS securitisations.

Article 26d(2): External verification of the sample

A sample of the underlying exposures should be subject to external verification prior to closing by an appropriate and independent party, including verification that the underlying exposures meet the criteria determining eligibility for the credit protection under the credit protection agreement.

The verification agent, typically an accounting firm, is well placed to test such sample, so this requirement either already exists, or should not pose a problem for most deals.

Articles 26(d)(3) to (5): Liability cash flow model; environmental performance of assets and compliance with transparency requirements

The requirements for synthetic STS securitisations under these provisions are similar to those for other non-synthetic STS securitisations. However, we do note that unlike non-synthetic STS securitisations, it appears that for synthetic STS securitisations the transaction summary to be made available before pricing should be in final form. It is not clear if this difference is intentional.

D. Criteria Specific to Synthetic Securitisations (Article 26e)

Article 26e(1): Credit events

The required triggers are Failure to Pay[5], Bankruptcy[6]; and in the case of credit protection other than financial guarantee, Restructuring[7].

Forbearance measures, which consist of concessions towards a debtor that is experiencing difficulties in meeting its financial commitments, should not preclude the triggering of the credit protection event.

Most CRTs do have triggers that comply with the CRR. Interestingly, with the current COVID-19 related crisis and the various forbearance measures introduced across many jurisdictions, the requirement that the deal can get triggered even with such forbearance, is quite relevant. The inclusion of such "forbearance" trigger should ameliorate the proposal that "financial guarantees" do not contain a "Restructuring" trigger, for reasons of a simpler accounting treatment.

Article 26e(2): Credit protection payments

The credit protection payment following the occurrence of a credit event should be calculated based on the actual realised loss suffered by the originator or relevant lender, as worked out in accordance with its standard recovery policies and procedures for the relevant exposure type and recorded in its financial statements at the time the payment is made.

An interim protection payment has to be made, at the latest 6 months after the credit event has occurred.

The method by which interim and final credit protection payments are calculated should be clearly specified in the credit protection agreement. The credit protection amount should be broken down to the level of individual underlying exposures.

Most CRTs already utilise this mechanism; therefore, many existing deals are already structured to reflect a pre-agreed percentage loss, which is then subject to a "true-up", after the defaulted asset has been worked out.

Article 26e(3): Credit protection payments following close-out/final settlement at the final legal maturity of the credit protection agreement

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5 which includes the default referred to in Article 178 (1)(b) of the CRR.

6 which includes the elements referred to in Article 178 (3)(e) and (f) of the CRR.

7 which includes the elements referred to in Article 178(3)(d) of the CRR.

If the work-out has not been completed 2 years after the scheduled legal maturity, the final protection payment should be made on the basis of the actual loss suffered by the originator (as recorded in its financials).

Many CRT would already have this feature, with a range of variations around evidencing the final loss, with some deals requiring an accountant's certificate, and others – confirmation by the originator.

Article 26e(3): Credit protection premiums

The premiums should be contingent and there should not be rebate mechanisms that reduce the losses of investors.

Article 26e(4): Verification agent

A third party should verify the occurrence of credit events, compliance with eligibility criteria and replenishment conditions and the accuracy of the final loss calculation.

Article 26e(5): Early termination events

The originator should only be allowed to terminate for regulatory change events and for clean-up calls. The originator can also terminate if the investor is insolvent, fails to pay or breaches its material obligations. Time calls are permitted under limited circumstances and cannot be used to provide credit enhancement to investors.

Article 26e(6): Synthetic excess spread

The protection buyer should not commit to any amount of synthetic excess spread ("**SES**") available to investors, unless certain strict conditions are met: (i) fixed SES; (ii) use-it-or-lose-it mechanism; and (iii) the total committed amount every year may not be higher than the one-year regulatory expected loss on the underlying portfolio.

The issue of SES in CRTs has been subject to ongoing debate. The regulatory concern is that if the amount of SES subordinated to the investor position is too high, then the investor's position will not be eroded by losses, resulting in no effective risk transfer. On the other hand, SES is quite important for some asset classes (e.g. SME and consumer lending) that benefit from the higher yield for investors and for which the underlying exposures generate higher losses and excess spread to cover for those losses.

Article 26e(7)-(9): Eligible credit protection agreement, counterparties and collateral

The only permissible credit protection arrangements are:

- a guarantee meeting the requirements of Chapter 4, Part Three, Title II of CRR, by which the credit risk is transferred to a central bank, a regional government, a public sector entity or a multilateral, provided that the exposure of the protection seller qualifies for a 0 per cent. risk weight;

- a guarantee meeting the requirements of Chapter 4, Part Three, Title II of CRR with the benefit of a counter-guarantee by the above entities, or

- other credit protection in the form of a guarantee or a credit default swap that meets the requirements of Sub-Section 2 of Section 3, Chapter 4, Part Three, Title II of CRR, provided that collateral is provided in the form of cash or 0 per cent. risk-weighted debt securities.

Most CRT investors will not be recognised by the CRR as being eligible for a 0 per cent. risk weight, thus attracting a requirement to fund the credit protection by providing high-quality collateral. The requirement that (A) the collateral in the form of 0 per cent. risk-weighted debt securities should be held with a third party (such as EU government securities or securities of supranational entities held in a trust or a similar entity); and (B) when it is in the form of cash, it should be held either with a third-party credit institution or on deposit with the protection buyer, subject in both cases to a minimum credit quality standing, is already a commonly negotiated feature in many CRTs.

Conclusion

A significant number of European synthetic securitisations entered for the purpose of capital relief are likely to comply with the proposed STS criteria, as a result of market developments and CRR requirements. Given the sophistication of investors in such deals, features such as the provision of cover for unhedged exposures, detailed eligibility criteria, restricted replenishments and strict scrutiny of servicing standards are already common features of most European deals.

Next Steps

The next step is for the European Parliament and the Council to review the Commission proposal and adopt a legislative text. The legislative text adopted may differ from that in the Commission proposal to reflect changes required by the European Parliament and/or the Council. The legislative process for adoption of the current Securitisation Regulation saw a number of such changes being made to the version originally proposed by the Commission. Addressing levels of NPEs held by banks was already a significant issue in a number of EU member states prior to the commencement of the COVID-19 pandemic. The COVID-19 pandemic has led to an expectation of increased NPEs. Synthetic securitisation has been a politically sensitive issue since the 2008-10 financial crisis which is one of the reasons that the STS framework under the Securitisation Regulation currently excludes synthetic securitisation.

The amendments will apply directly to Member States 20 days following publication in the Official Journal of the European Union of the adopted legislative text.

Brexit and Application in the UK

The transition period under the UK-EU withdrawal agreement runs until 31 December 2020. If the legislative text containing the proposed amendments is agreed and takes effect prior to the end of the transition period, then it, being a regulation, will automatically become part of UK law, but the UK will be free to modify the Securitisation Regulation with effect from 2021 onwards. Based on the typical timeframe for adoption of EU legislation by the European Parliament and the Council of Ministers, it is not expected that the legislative text will take effect by 31 December 2020. In that case, the legislative text and the amendments will not become part of UK law. As the existing Securitisation Regulation will nonetheless remain part of UK law after the end of the transition period, we look forward to hearing from the UK Treasury, Prudential Regulation Authority and the Financial Conduct Authority regarding whether the UK proposes to make amendments to UK law that correspond to the proposed amendments adopted by the EU.

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

Suzanne Bell	+44 (0) 20 7170 8549	suzanne.bell@cwt.com
Robert Cannon	+44 (0) 20 7170 8735	robert.cannon@cwt.com
Stephen Day	+44 (0) 20 7170 8535	stephen.day@cwt.com
Matthew Duncan	+44 (0) 20 7170 8730	matthew.duncan@cwt.com
Claire Puddicombe	+44 (0) 20 7170 8533	claire.puddicombe@cwt.com
David Quirolo	+44 (0) 20 7170 8635	david.quirolo@cwt.com
Nick Shiren	+44 (0) 20 7170 8778	nick.shiren@cwt.com
Daniel Tobias	+44 (0) 20 7170 8630	daniel.tobias@cwt.com
Assia Damianova	+44 (0) 20 7170 8564	assia.damianova@cwt.com
Michael Sholem	+44 (0) 20 7170 8545	michael.sholem@cwt.com
Elena Bernal	+44 (0) 20 7170 8772	elena.bernal@cwt.com