

Clients&FriendsMemo

Update on the EU STS and Risk Retention

25 May 2016

Introduction

On 19 May 2016, the Committee on Economic and Monetary Affairs of the European Parliament (“ECON”) published a working document on the European Commission’s proposal for a regulation (the “**Proposed Regulation**”) intended to harmonise risk retention, transparency and due diligence requirements applying to securitisations and to create a legal framework to encourage “simple, transparent and standardised” securitisations (“**STS securitisations**”).

Legislative Background

The Commission’s Proposed Regulation was announced on 30 September 2015, together with a proposal for amendments to the Capital Requirements Regulation (the “**CRR Proposal**”) designed to reduce the regulatory capital requirements for exposures to STS securitisations. We discussed the Commission’s original proposal in our briefing note dated 1 October 2015¹.

The European Council then moved rapidly in its considerations of the Proposed Regulation and on 30 November 2015, the Presidency of the Council published its “third compromise proposal”, which is the Council’s agreed negotiating position (discussed in our briefing note dated 17 December 2015²).

Progress through the European Parliament

The Proposed Regulation is now being considered by the European Parliament, which in contrast to the Council, is taking much more time in its deliberations.

ECON, under Rapporteur Paul Tang MEP, is currently reviewing the proposals in detail. The working document dated 19 May 2016 (the “**Draft Report**”) indicates the approach that Paul

¹ <http://www.cadwalader.com/resources/clients-friends-memos/securitisation-keeping-it-simple>

² <http://www.cadwalader.com/resources/clients-friends-memos/update-on-the-eus-proposed-regulation-on-securitisation-and-its-potential-impact-on-us-market-participants>

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Tang intends to take on the Proposed Regulation. Paul Tang is coordinating his work with that of a separate working group in ECON which is considering the CRR Proposal. There was a first exchange of views on the Draft Report within ECON on 24 May 2016.

Proposed European Parliament Timetable

ECON's intended timetable is that:

- there will be a public hearing on 13 June 2016 and consideration of the Draft Report on 21 June 2016;
- the deadline for amendments is late July 2016;
- ECON will then consider the amendments in October with voting taking place in ECON in November 2016; and
- the European Parliament's full vote is not due until mid-December 2016.

Some MEPs have criticised the length of this process and have compared it unfavourably with the speed at which the Council produced their amendments to the Proposed Regulation. The timetable may therefore be shortened, but probably by no more than about a month.

Once the European Parliament has developed its proposals, the three EU legislative institutions will negotiate a common position in a process known as trialogue. Once the final text is agreed and approved, the Regulation will be published in the Official Journal of the European Union. It is due to enter into force 20 days after publication and shall apply to securitisations the securities of which are issued on or after that date, subject to transitional provisions. It will apply directly across the EU without the need for separate legislation in each EU Member State.

The Key Issues in the Draft Report: Asymmetric Information and Moral Hazard

The Draft Report starts with a summary of the advantages and disadvantages of securitisation, and then provides an analysis of what is viewed to have gone wrong in the securitisation market in the past. "Asymmetric information" and "moral hazard" are identified as being the two fundamental issues that need to be addressed.

The Draft Report notes that asymmetric information exists between the issuer and the investors, with the issuer knowing much more about the security, the credit quality of the underlying loans, the profile of the credit receivers and the relative quality of the different tranches.

It then describes how asymmetric information can give rise to problems of moral hazard, because of a misalignment of interests between the parties in a securitisation. To address the

potential problems of moral hazard, the different interests of the market participants need to be aligned. Asymmetric information can be dealt with by strengthening transparency requirements.

Transparency and Proposed Public Register for STS Securitisations

The Draft Report stresses the importance of transparency within the securitisation market so that investors, regulators and the market as a whole can better understand the sources of the key risks in a securitisation.

In this context, the Draft Report considers that a public register for STS securitisations would improve transparency, both as regards securitisations and their underlying assets. This would assist market participants as well as regulators. It proposes that key data could be sent to a trade repository, with loan-level data being anonymised in order to protect confidentiality. It considers that the availability of this data would also facilitate market participants being able to assess better the risks of the underlying loans, and would assist investors generally in this loan-level data being publicly available.

Risk Retention and Moral Hazard

The importance of the risk retention requirements in overcoming moral hazard is recognised in the Draft Report. It notes that alternative mechanisms to align interests have been looked at by the European Banking Authority ("EBA") and the Commission, but that these alternatives were thought to have been too complex to establish and too difficult to enforce. It notes, however, that Paul Tang "is open to strengthening the risk retention rules if necessary" and refers to the recent EBA report which proposes that regulators' supervision practices could be improved and harmonised in relation to risk retention.

The Importance of Setting the STS Criteria at the Right Level

The Draft Report highlights the challenges in clarifying the distinction between STS and non-STS securitisations and the consequences of this delineation in creating a two-tier market for securitisations. Paul Tang believes that a balance needs to be achieved between making the criteria so restrictive as to undermine market take-up and making the criteria insufficiently stringent so as to avoid riskier forms of securitisation being classed as STS.

In this context, the Draft Report stresses the necessity for "clear, quickly-applicable and uniformly-enforced criteria for the STS concepts" and the importance of the STS being sufficiently certain so as to avoid the possibility of "loopholes." It indicates support for greater clarification in the definition of certain aspects of the STS criteria.

It believes that there should not be an intention to eliminate non-STS securitisations, but that the aim should be to ensure that those who carry the risk in non-STS securitisations are aware of the nature of those risks and have sufficient assets to cover any potential losses.

It also supports moving towards a single European interpretation of STS criteria, by limiting the number of authorities involved in such an interpretation.

Asset-Backed Commercial Paper (“ABCP”)

The Draft Report discusses some of the difficulties in applying the STS regime to ABCP securitisations. It highlights the importance of car lease and loans in the ABCP market and views that they should be included within the STS regime.

Self-Attestation and Penalties for Non-Compliance

The Draft Report supports the Commission’s proposals for self-attestation of STS compliant securitisations, with the responsibility for adhering to the STS criteria lying with issuers and investors.

It notes that the strictness of the applicable penalties for non-compliance is a reflection of the self-attestation nature of the STS regime. It points out that having a strict penalty regime should not however be a substitute for a failure to have clear STS criteria, and warns that severe penalties could act as deterrent for investors.

The Draft Report is of the view that to reduce divergent interpretations as regards the application of the Proposed Regulation, the authorities involved in interpreting the STS rules should be restricted to the national securities markets regulators, with the European Securities and Markets Authority taking on a central role.

Balance Sheet Synthetics and SME Securitisations

The Draft Report recognises that synthetic transactions that are used by institutions to transfer credit risk, i.e. balance sheet synthetic transactions, have a default rate no worse than that of traditional securitisations, and so should not, in principle, be deemed to be too complex to fall within the STS regime.

It notes that SME loans have only formed a small part of the overall securitisation market in Europe and believes that SME securitisations should be encouraged through the STS proposals. It considers that a regulatory framework for synthetic securitisations within the STS regime could help develop the SME securitisations market in Europe.

Interaction with Other Markets and Investment Products

The Draft Report points out that an assessment of the attractiveness of the STS regime for investors and issuers should not be looked at in isolation, but in conjunction with the indirect effect of the proposals on other investment products such as covered bonds and whole loan portfolios. Any developments in the securitisation market that affect (positively or negatively) the

markets for these other instruments should also be considered in looking at the overall consequences of the Proposed Regulation.

Third Country STS Securitisations and Equivalence of Non-EU Regimes

The Draft Report looks at whether or not it would be sensible to include a mechanism for determining whether a third-country STS regime is equivalent to that in the EU, having regard to the access to the EU market by non-EU entities. It concludes that, since the EU has been a first mover in creating an STS regime, it would be difficult to create an equivalence regime for non-EU jurisdictions at this stage, but that a review of this issue at a future date would be a more appropriate approach.

Conclusion

The conclusion of the Draft Report highlights the potential economic benefits of securitisation. However, in order to realise such economic advantages, the Draft Report stresses the importance of dealing with the issues of the asymmetry of information and moral hazard through the STS framework.

As regards moral hazard, it approves of the proposed self-certification process that seeks to prevent market participants from relying solely on third parties such as credit rating agencies, and which puts the onus for compliance with the STS regime on issuers and investors.

In respect of asymmetry of information, it stresses the relevance of transparency, citing the importance of disclosure rules for issuers and the due diligence requirements for investors. One of its key recommendations is a public register to contain information on STS securitisations, which it considers would allow regulators to keep track of the securitisation market and would be of assistance generally to market participants.

The Draft Report acknowledges the real gains to the EU economy that would arise from a revival of the EU securitisation markets, and so is broadly supportive of the legislative proposals designed to encourage STS securitisations and to improve the functioning of the securitisation markets.

We would note that this is in contrast to the position of those MEPs who remain suspicious of securitisation in general. A number of MEPs are sceptical that the benefits of securitisation outweigh its potential risks. Even amongst those who are broadly supportive of the proposals to revive the European securitisation market, many view the Proposed Regulation with caution and intend to scrutinise it closely. Given the concerns of many MEPs, it appears that the legislative progress of the Proposed Regulation through the European Parliament will not be as quick as the European Commission had originally anticipated.

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