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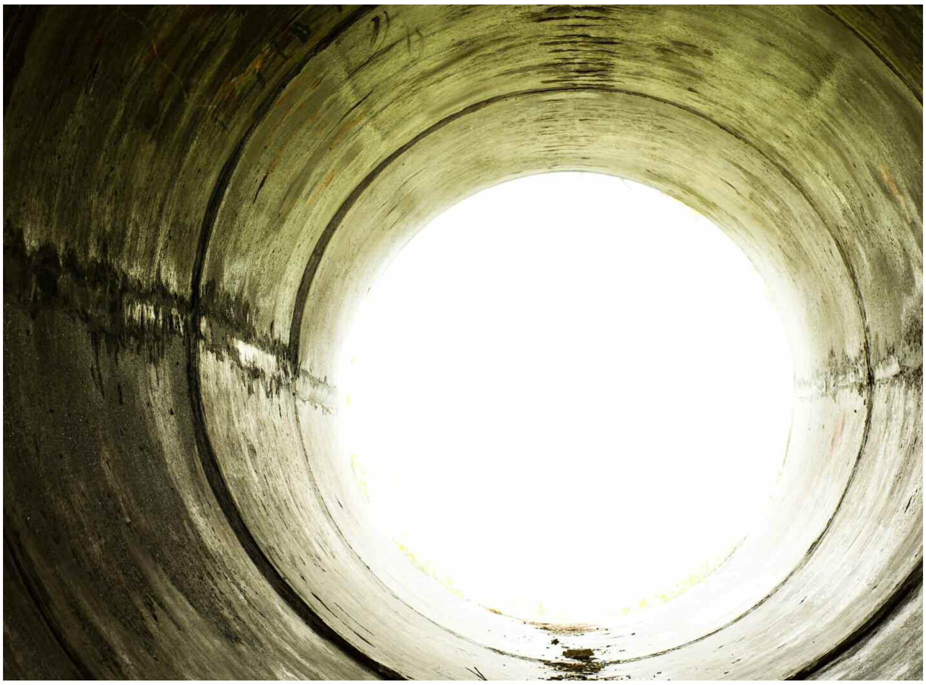
# Developments in European regulation on securitisation – what's left in the pipeline?

The securitisation market faces tougher regulation. Clifford Chance experts outline the current regulatory landscape and assess what may lie ahead.



Since the beginning of the global financial crisis, the securitisation market has seen a range of regulatory proposals aimed at curbing excessive risk taking. These proposed changes are numerous, complex and, in some cases, the unintended consequence of measures aimed at other areas of the financial markets.

Perceptions of securitisation are changing – from being seen as part of the problem, to being recognised as part of the solution, as one of a range of possible routes to providing funding for the real economy.

Although politicians and senior regulators understand the case for securitisation and its value in the current credit environment, "the technocrats working on the regulations are still drafting the detail in ways that can be problematic," says Kevin Ingram, a partner in Clifford Chance's Capital Markets practice.

This is not helped by the fact that securitisation is often used as a guinea pig by regulators implementing new regulation. For example, the proposed new Basel framework for securitisation is effectively creating additional capital charges around modelling that, in due course, will probably find their way into other products. Add to this the concerns, that changes not specifically aimed at securitisation will actually have a big impact, and there is a fear that the playing field may be tilting even further away from securitisation. "If you start penalising securitisation from a regulatory perspective, other products which are less impacted will clearly start to become more attractive," explains Kevin.

Having put up these general markers, it is important to separate out the main areas of regulation affecting securitisation and examine their impact.

## CRD IV and liquidity

A recent Basel Committee paper on liquidity suggests that certain securitisation instruments should be capable of being held in the liquidity pool. CRD IV does not go quite that far, but a stated obligation to maintain 'sufficient' liquid assets leaves it largely up to the banks, or more specifically to their national regulators, to decide what 'liquid' means in this context. Over and above that, there is a reporting requirement which is based on broad categories and a mandate to the European Banking Authority (EBA) to write clear rules by 2015.

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Simon Gleeson, a partner in Clifford Chance's Financial Markets practice, believes that "the broad position of most European regulators appears to be in favour of allowing senior securitisation paper to be used in the liquidity pool, but we don't quite know yet". He also identifies a potential problem in that there are "certain things that you cannot use in your liquidity pool for reporting purposes and one of those is paper issued by financial institutions". Given that the question of whether or not a securitisation is a financial institution is problematic, this is likely to remain an issue until the final EBA rules are clarified.

## CRD IV Article 122a (now Articles 404 - 410) – skin in the game

There are two main areas of change here relating to securitisation. The first is that a new method of retention is being introduced, "which means that the skin in the game can be fulfilled by a holding of 5% in each underlying asset," says Martin Sharkey, a senior associate in Clifford Chance's Capital Markets practice. Secondly, the identity of the entities which can satisfy the retention requirements is also going to be adjusted. "So what we are going to see is a widening out of the definitions so that investment firms can hold the 5% skin in the game, whilst cutting back on any flexibility for entities outside the CRD IV definitions, such as equity investors who are involved in structuring the securitisation and selecting the initial portfolio to hold the skin in the game," says Martin. "This is causing some concern for those involved in deals such as managed CLOs, where the skin in the game in most recent deals has been held by the main equity investor rather than an investment firm asset manager".

"We are currently in a consultation that will run to the end of August. So I think we will see lobbying from the market to try and get some of the flexibility back but it is unlikely that this will be successful," he adds. If the skin in the game requirements are not satisfied, increased capital sanctions would not apply to transaction parties such as originators or arrangers, but to any investors who through negligence or omission enter into deals where there is a failure to disclose that the skin in the game requirements are satisfied.

## Data and reporting

One of the consequences of the financial crisis was a huge increase in the amount of data that market participants need to provide, all of which has to be stored somewhere. The European Data Warehouse was launched in June 2012 with the encouragement of the European Central Bank (ECB) and rules concerning ECB eligibility are continuing to evolve. Currently, loan-level data on securitisations needs to be reported on templates and deposited at the Data Warehouse. Since 3 January 2013, RMBS and SMEs have been required to use the mandated ECB data template; from 1 January 2014, the same will apply to consumer finance ABS, leasing ABS and also loan ABS. Other asset classes may be added in due course. There are some transitional periods but effectively, after nine months, there will be no more transitional relief. "A feature of the securitisation landscape in Europe going forward will continue to be provision of loan-level data, probably through the European Data Warehouse," notes Kevin.

For those looking at undertaking deals in EU jurisdictions with lower sovereign debt ratings, it is important to note that, unless you comply with these loan-level reporting requirements, you may not continue to benefit from the temporary arrangements put in place. These enable some of the seven European countries with lower ratings to get ABS into the ECB.

Finally, although credit cards are very low on the ECB priorities, financial institutions in a number of European jurisdictions (particularly some with sovereign ceiling issues) are starting to look at credit card collateral as being good collateral for the ECB. At the moment there is no loan-level reporting template but there are working groups exploring this issue. "It is probably too early to say where this will end up," Kevin says.

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## CRA 3

The latest Credit Rating Agencies Regulation (this package of amendments is commonly known as "CRA3") was published at the end of May and came into force on 20 June 2013. "The first point to note is the rules around reducing reliance on credit ratings, which means that Europe will in due course, I suspect, go much along the same sort of lines as the US in minimising the use of ratings in regulation. CRA 3 also makes it clear that mandatory rotation of rating agencies will only apply for resecuritisations," explains Kevin.

The next area to consider is the disclosure requirement for structured finance instruments. Apart from the initial problem that this requires data to be made available on a website that has not yet been set up, the concern is that the requirement applies more broadly than just to rated debt. In fact it may extend to all deals that could be viewed as securitisations. It could therefore apply even to a private transaction between two entities within the same group, meaning that information about the transaction would have to be placed on a public European Securities and Markets Authority (ESMA) website. "As yet no draft technical standards have come out from ESMA on this and a finalised RTS [key regulatory technical standards] is not required for another year," says Kevin, "so it will be important to keep abreast of developments." (ESMA published a discussion paper in early July.)

Finally, dual rating requirements. For mainstream securitisations this should not be too problematic, but in the private market and for bespoke transactions, it is potentially more difficult as in practice one rating is often all that is required. On the use of smaller agencies, "there is nothing from ESMA about the precise rules, but we think it is likely to be more of a consideration and disclosure issue rather than actually forcing an issuer to use smaller agencies," explains Kevin.

As there are no grandfathering arrangements, the issue of whether a transaction is judged to have predated the new regulations which came into force on 20 June 2013 will be crucial. The key phrase in the regulation is "intending to solicit", with no certainty about what that means and no clear guidelines as yet from ESMA. So, as Kevin explains, there is currently a lot of debate around "whether a discussion with the agencies is enough – probably not; whether signing a letter with the agencies is enough – possibly; or whether you need to have gone all the way to having an assignment of a rating – definitely, but the regulation clearly contemplates a point prior to this as having met the requirements. The current uncertainty is causing some difficulties at present for transactions that are well advanced".

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## Large exposures

The basic rule here is that banks cannot have more than 25% of capital exposed to any single name. No real problem here for securitisations; but what about the rules for investing in so-called 'blind pools' where the bank does not know who or what the underlyings are? Here the regulators are trying to stop banks which may be up to their limit on one particular name from buying an exposure to a pool of assets that, in fact, contains further assets issued by that particular name.

So far, so rational, but: "the problem is that although this makes perfect sense if the bank is buying, for example, a unit in a fund, what happens when it is buying a senior piece of a securitisation which is exposed to underlying names that it wouldn't be allowed to lend to directly?" asks Simon. In other words, how do you relate tranching to a rule that was conceived to deal with vehicles that are not tranched? It appears the EBA's answer is that you ignore the tranching. "So if a particular securitisation has an exposure to name X and you buy 50% of the senior paper, then you will be treated as having 50% of that securitisation's exposure to name X," explains Simon.

This may appear harsh as it does not take into account the protection that the owner of the senior piece is given by the equity piece and the intermediate pieces. "But", Simon adds, "the reason it makes sense, from a regulatory point of view, to ignore the protection constituted by the junior tranches is that, if you made a loan to name X and bought protection over the first 50% of losses on that loan, then, for large exposure purposes, that protection would also be ignored".

The regulators are also concerned about the possibility of lenders deliberately blinding themselves to the underlying basket in order to increase their exposure to a name. To prevent this they have ruled that any exposure to an unknown name must be applied to a single fictional client called X, and the bank's exposure to X must be limited to 25% of capital, just as with any other name. "This is effectively a prohibition on banks investing any significant amount of money in any pool of assets in which they do not have precise details as to the underlying names," adds Simon.

## Solvency II and AIFMD

"In effect, what the CRD does for credit institutions, Solvency II does for insurers and AIFMD does for collective investment undertakings," explains Martin Sharkey. Their common purpose is to ensure that the entities they regulate are financially sound, have sufficient capital to meet their liabilities and also operate in a harmonised 'level playing field' across the whole of the EU. Certainly, in terms of skin in the game, Alternative Investment Fund Managers Directive (AIFMD) and Solvency II have similar requirements to CRD IV.

There is less harmony in terms of timing: AIFMD was required to be transposed into national laws by 22 July 2013 but

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Solvency II is at a less advanced stage and a best guess at the moment is that it could come into force at some time from 2015 or 2016. While securitisation aspects of Solvency II are not high up the list of live issues for the big insurers at the moment, they could nonetheless have a significant impact for those looking to invest into securitisation paper. So an unintended consequence of Solvency II could be to reduce the potential of insurance investors to support growth in Europe.

## Basel securitisation framework

Proposals for the revision of the Basel securitisation framework were released by the Basel committee at the end of 2012. While these include some significant changes, it is important to remember that this was a consultative document and how much of it will become regulation or legislation at Basel or European level remains to be seen.

The document proposes changing the hierarchies for risk weighting, with two different hierarchies in place. "There is a US approach and there is a more European approach, as the Basel committee obviously reflects the global community of central bank regulators," says Kevin.

The next point of interest is that the minimum capital charge for senior positions increases significantly, effectively from 7% to 20%, but there is a reduction in the risk weighting for the junior positions. This is as a result of the Basel committee looking at behaviours and observing that the junior tranches "stood up pretty well in the global financial crisis but that the risk weighting associated with the senior tranches was too little," adds Kevin.

There are also recommendations on resecuritisations, regarded by some in the regulatory community as the black sheep of the structured finance world. According to the proposals, resecuritisations will in future be risk weighted using the relatively penal concentration ratio approach and this could have a major impact on the use of products involving resecuritisation.

Other key areas proposed by the Basel securitisation framework include: the imposition of a 20% risk weight floor for securitisation exposures; new approaches and modifications to risk weighting including longer maturities; and the introduction of the back-stop concentration ratio approach. The proposals also include the introduction of a capital charge ceiling, the elimination of especially favourable treatment for ABCP investments and eligible liquidity facilities, and the removal of any regulatory capital benefit of securitisations of revolving assets with early amortisation features.

One final point to highlight is that the Basel committee recommendations mean that it will effectively not be possible, in a typical master trust securitisation, to get any regulatory capital relief. Although this is "not a big issue at present as issuers use their master trusts for funding only, it is an interesting development conceptually," says Kevin.

There is a lot to grapple with. The initial consultation period ended mid-March 2012 and the industry is waiting to see what will come back out of Basel while continuing to engage on a modelling approach and data inputs.

"It seems the European regulators are more comfortable with securitisation than the American regulators are at present. As a result there may be tensions within the Basel committee as to how conservative or penal the new framework is going to be," says Kevin.

## EMIR

In general, EMIR's recent regulation requiring the mandatory clearing of standardised swaps appears unlikely to have much effect on mainstream securitisation. Yet as most of the interest rate and forex swap world moves onto clearing, and requires hedging, there will be issues. Here, the collateral requirements of clearing are likely to cause major concerns, particularly for synthetic securitisation. How does a securitisation vehicle give collateral? What is the impact of a securitisation vehicle giving collateral on its rating?

The answers are hard to find but Simon Gleeson believes "if derivatives are to play any significant part in the architecture of securitisations going forward, then either a whole new channel of payments will need to be

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built in order to deal with collateralisation arrangements, or deals will have to be structured in such a fashion as to fall outside the EMIR framework, which is likely to be extremely difficult".

The other point is that if anything other than an entirely standardised swap is required, there are a relatively small number of banks capable of structuring and selling it. "If you are not one of those, you are going to have to put some sort of back-to-back arrangement in place between that entity and your vehicle. Then you have two swaps and two sets of analysis to do, about what has to be collateralised and what has to be cleared," explains Simon, who feels that those drafting EMIR have not necessarily thought this aspect fully through. As a result, those involved in securitisations that use derivatives may well need to adopt an innovative approach to navigate these hurdles.

## Shadow banking

The Financial Stability Board (FSB), as mandated by the G20, has a number of work streams looking at shadow banking and one of these relates to securitisation.

The FSB is looking at regulating securitisation in terms of maturity transformation, liquidity transformation, leverage and arbitrage: "Things that were never very popular in the regulatory community and fall squarely within their concerns around shadow banking," says Kevin. However, there is also a recognition that securitisation can be an important element to the stable growing economy.

This may, to some extent, be because "the industry has done a fairly good job at pushing back at these work streams and saying that a lot of the issues raised are either misplaced or covered by existing regulation," says Kevin. "So, although there is some concern about the negative associations of shadow banking and the part securitisation plays in it, there is also a feeling that the industry is at least being heard."

## Outlook

First, the good news: regulators and policy makers are more willing to see that securitisation has a positive role to play and there are fewer "securitisation is a problem" regulations proposed. However, other areas of regulation are starting to impact securitisation and these are not so well sign-posted but nonetheless could have significant, if sometimes unintended, consequences.

As Kevin Ingram concludes: "Although we're coming to the end of the big bulk of new regulation there is still a lot of work to do, and we will undoubtedly be hit with side winds from other bits of regulation as well. So I think for the next few years market participants will need to be watchful, wary and well advised as they navigate this new environment".

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