

Regulatory News Alert

EU Securitization Regulation 2017/2402 - Overview

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Aim of the regulation

The new regulation came into force in January 2018 and becomes applicable as of 1 January 2019, with the intention of providing a general framework for securitization across the EU. The EU stated:

"The development of a simple, transparent and standardized securitization market constitutes a building block of the Capital Markets Union (CMU) and contributes to the Commission's priority objective of supporting job creation and a return to sustainable growth."...

"Securitization is an important element of well-functioning financial markets. Soundly structured securitization is an important channel for diversifying funding sources and allocating risk more widely within the Union financial system. It allows for a broader distribution of financial-sector risk and can help free up originators' balance sheets to allow for further lending to the economy."

What is in it?

Chapter 1 of the regulation establishes requirements for, among other things, due diligence, risk retention, and transparency for all those involved in securitization. There is a list of definitions, including one for securitization, in which the EU defines it as:

"... a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranching, having all of the following characteristics:

(a) payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures;

(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;

(c) the transaction or scheme does not create exposures which possess all of the characteristics listed in Article 147(8) of Regulation (EU) No 575/2013."

The regulation introduces a ban on resecuritizations, subject to derogations such as for some asset backed commercial paper programs, as they can reduce transparency.

Entities captured by the regulation

The regulation is aimed at the following entities:

- Institutional investors
- Originators
- Sponsors
- Original lenders
- Securitization special purpose entities (SSPEs)

Institutional investors are defined as:

- Both insurance and reinsurance undertakings
- Institutions for occupational retirement provisions
- Alternative investment fund managers
- UCITS, both self-managed and management companies of them
- Credit institutions
- Investment firms

Key requirements

A. Article 5, Due diligence – Institutional investors will need to verify:

- the processes and procedures of the originator/original lender, from both EU and third countries, to grant the credits underlying the securitization obligation;
- the originator/sponsor/original lender, from both EU and third countries, has retained at least a 5% material net economic interest in the obligation as per article 6;
- the originator/sponsor/original lender, from both EU and third countries, has provided the required information set forth in Article 7;
- they have written procedures in place that are proportionate to the risk profile of the position held on an ongoing basis.

B. Article 6, Risk retention – Aligning interests with those of investors:

- the originator/sponsor/original lender shall maintain a material net economic interest in the securitization of at least 5% (not subject to hedging, credit risk migration);
- the retention shall be held by either the originator, sponsor, or original lender, and cannot be shared;
- if the originator, sponsor, or original lender are unable to reach an agreement on who retains the risk, the risk retention shall be borne by the originator.

C. Article 7, Transparency – Obligations of originators, sponsors, and SSPEs:

- supply (potential) investors, competent authorities, information on underlying exposures on a regular basis (quarterly, monthly dependent on securitization type);
- provide all documentation essential to understanding the securitization transaction (prospectus, offering doc, closing transaction doc, asset sale agreements, novation or transfer agreement, etc.)
- all required documentation should be made available at the securitization repository (where applicable) to enable investors with a single venue to help perform their due diligence.

Amendment to the UCITS Directive 2009/65/EC & AIFMD Directive 2011/61/EU

Chapter 6, Article 38 of this regulation will amend Article 50a of the Directive 2009/65/EC and it will be replaced by:

"Where UCITS management companies or internally managed UCITS are exposed to a securitization that no longer meets the requirements provided for in the Regulation (EU) 2017/2402 of the European Parliament and of the Council (), they shall, in the best interest of the investors in the relevant UCITS, act and take corrective action, if appropriate."*

As this regulation is applicable from 1 January 2019, institutional investors should be in the process of assessing the compliance of any securitization holdings with the regulation.

A similar amendment is also applicable for the AIFMD directive, for which AIFMs are invited to assess their positions in securitised instruments.

Article 17 of Directive 2011/61/EU is replaced by the following:

"Where AIFMs are exposed to a securitisation that no longer meets the requirements provided for in Regulation (EU) 2017/2402 of the European Parliament and of the Council (), they shall, in the best interest of the investors in the relevant AIFs, act and take corrective action, if appropriate."*

STS – Simple - Transparent – Standardized

As part of the regulation, the EU is seeking to establish a more risk-sensitive prudential framework for securitizations to follow and allow them to be labelled "STS." In a similar way to the UCITS brand for investing, the label STS will help investors in their own due diligence process. It will not negate the risks of the holding a position or indicate the quality of the underlying aspects of the securitization.

To be designated with the STS label, the originator, sponsor, or SSPE must be established in the EU, meet all requirements of Chapter 4, section 1 or 2, and have notified ESMA as per Article 27(1). Those securitizations that attain the STS label must be published on a list on ESMA's official website.

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