In Practice

Authors Sanjev Warna-kula-suriya and Christopher Anthony Sullivan

Bridging the Atlantic for securitisations

Throughout 2019 we have seen a steady stream of US securitisations in which US originators, sponsors, and underwriters have raised questions about complying with Regulation (EU) 2017/2402 (the Securitisation Regulation). This In Practice article provides some clarification.

INTRODUCTION

Historically, EU risk retention and disclosure requirements applied indirectly as a result of certain types of EU investors imposing contractual obligations in satisfaction of their regulatory due diligence requirements. The indirect approach continues under the new rules, but applies to virtually all regulated financial services sectors, including banks, investment firms, insurers, reinsurers, pension funds, alternative investment funds, and undertakings in collective investment in transferable securities (EU institutional investors).

In contrast to obligations imposed on transactions issued before 1 January 2019, the Securitisation Regulation imposes risk retention, disclosure, and credit granting-related obligations directly on originators and sponsors. This approach, while novel to the European securitisation market, is well-established in the US, where risk retention rules apply directly to "securitizers".

US transaction and disclosure documentation may not always need extensive tailoring for EU requirements. A good starting point is to determine if the transaction is a "non-securitisation transaction", which structurally falls out of scope altogether, or a "non-conforming transaction", which should be outside the geographic reach of the Securitisation Regulation's direct obligations. Either way, the depth of EU regulatory review will be less intrusive than for "conforming transactions".

NON-SECURITISATION TRANSACTIONS

Transactions considered to be securitisations under US law might not necessarily be caught by the EU definition (and vice versa). The difference between the two is subtle. However, the regulatory perimeters on both sides of the Atlantic do not overlap completely. Structurally, non-securitisation transactions fall outside the EU definition, which is (broadly): a transaction or scheme, in which the credit risk of a pool of exposures is tranched, payments in the transaction or scheme depend on the performance of the pool of exposures, and the subordination of tranches determines the distribution of losses during the life of the transaction.

In the US, the definition of securitisation involves the issuance of fixed-income securities collateralised by self-liquidating financial assets, in which payments to the security holder depend on cash flows from the assets. The issuance of securities is not required to constitute a securitisation in the EU, resulting in a broad range of transactions being caught, such as unfunded portfolio credit hedges and asset-backed warehouse facilities.

A transaction should not be a securitisation under the Securitisation Regulation if the underlying exposures are primarily "equity" or "market" risk in nature. For example, private equity-backed structures involving equity and debt components may fall outside the definition if they do not tranche a significant amount of credit risk. However, this will be fact-dependent, and US originators and underwriters should obtain legal advice before proceeding on the basis that a transaction is a non-securitisation transaction.

NON-CONFORMING TRANSACTIONS

Non-conforming transactions are subject to the Securitisation Regulation indirectly if EU institutional investors are involved. Taking a purposive approach, the direct obligations should apply only if at least one of originator, original lender, sponsor, or issuer is established in the EU. The European Banking Authority (EBA) supported this view in its July 2018 response to industry on draft risk retention technical standards. However, this view is not formalised in the legislation, and does not cover EU disclosure or credit granting-related requirements.

Unlike in the US, there is no "foreign safe harbour" for offshore transactions, and the Securitisation Regulation has little or no geographic limits in the definitions of originator, original lender, and sponsor. In addition, "established" is not defined, which begs the question whether such entities must have a physical presence or be incorporated in a member state for the direct obligations to apply.

Amendments introduced under Regulation (EU) 2019/876 clarified that non-EU subsidiaries of EU institutional investors are subject only to the EU due diligence requirement on a consolidated basis (as opposed to the entire framework). This change would be ineffective if there was an overriding application of the direct obligations on non-EU originators, sponsors, and original lenders. With this in mind, the following steps should help steer a US transaction away from becoming a conforming transaction:

- use issuers established only in non-EU jurisdictions;
- ensure that collateral managers in existing US collateralised loan obligation transactions have consent rights in respect of refinancing and/or issuing new securitisation positions (to maintain grandfathering);
- include legends and selling restrictions in the offering memorandum and subscription agreement warning that the issuer, originator, sponsor, and underwriters will not attempt to comply with, or provide information required under, the Securitisation Regulation (but may choose to do so at a later date); and

- include a risk factor that the marketability of the securities and regulatory capital treatment of holding them may be affected as a result.

Prior to 1 January 2019, originators in US transactions marketed to EU institutional investors commonly undertook (often in a side letter) to retain an economic interest of 5% in the securitisation under legacy risk retention requirements, even when there was little appetite to comply with other requirements. EU institutional investors may still invest, provided the transactions were issued before that date. However, without the benefit of accessing EU investors, the old practice of providing an EU risk retention undertaking may simply invite added liability for new, non-conforming transactions.

CONCLUSION

When faced with tight timelines for reviewing US securitisation transactions, EU practitioners can limit their comments by categorising them as non-securitisation transactions or non-conforming transactions. While it may still be common practice for US originators to include EU risk retention undertakings without intending to comply with EU disclosure and credit granting-related requirements, it should be clarified that, without full compliance, EU institutional investors may not invest. ■

Biog box

Sanjev Warna-kula-suriya is a partner in the London office of Latham & Watkins and Chair of the Global Structured Finance and Securitization Practice. Email: sanjev.warna-kula-suriya@lw.com

Christopher Anthony Sullivan is a knowledge management lawyer in the London office of Latham & Watkins.
Email: christopher.sullivan@lw.com