LATHAM & WATKINS

Latham & Watkins delivers innovative solutions to complex legal and business challenges around the world. From a global platform, our lawyers advise clients on market-shaping transactions, high-stakes litigation and trials, and sophisticated regulatory matters. Latham is one of the world's largest providers of pro bono services, steadfastly supports initiatives designed to advance diversity within the firm and the legal profession, and is committed to exploring and promoting environmental sustainability.

In Practice

Authors Sanjev Warna-kula-suriya and Christopher Anthony Sullivan

Loan portfolio sales and securitisation

In Europe, the market for loan portfolio sales continues to thrive due to post-financial crisis bank deleveraging and a renewed focus on regulatory capital efficiency and return on capital. This In Practice article highlights key issues to consider when disposing of loan portfolios by way of securitisation.

Loan portfolio sales include assets such as commercial and residential mortgages, credit cards and consumer loans, trade receivables, and corporate and small/medium sized enterprise (SME) loans. Loans are primarily sold by way of private sale or auction and financed through bank debt and/or securitisation.

In a securitisation, assets are transferred to a special purpose vehicle (SPV), which funds the purchase by issuing different classes of debt securities, which are backed by the purchased assets and often rated by credit rating agencies. For purchasers of junior securitisation tranches, including funds, insurers and asset managers, the relatively small tranche size creates a leveraged exposure to the entire portfolio.

When an auction includes a direct purchaser and a bidder who intends to securitise the assets, the latter will usually offer a higher bid. Encouraging higher bids is especially crucial for sales of non-performing loans (NPLs), as sellers will seek to reduce the discount between the book value and purchase price.

Alternatively, assets can be sold to a warehouse vehicle funded by an asset-backed loan or loan note facility offered by a single lender or a small number of lenders, often followed by a securitisation "takeout".

At the outset, the seller will identify the portfolio of loans to be transferred and establish a cut-off date on which the economics will pass to the purchaser. This typically occurs a number of months before completion.

Approaches to due diligence on the portfolio vary according to the type of asset. Granular consumer loans often involve a review of the standard forms and a sample of the live loan files. For large, chunkier corporate loans, bidders may need to review each loan individually. For large commercial mortgages or leveraged loans, bidders need to fully understand any intercreditor arrangements that could adversely affect their position. For NPLs, bidders typically focus on their workout strategy, including added costs or contractual restrictions relating to enforcement.

Bidders will look for representations and warranties from the seller relating to the assignability, enforceability, outstanding balance and title to the assets. Some sellers provide very limited representations and warranties and require that breaches in respect of individual loans be aggregated into *de minimus* baskets of liability before a purchaser is able to bring a claim. Transactions may also include time limits on claims or a cap on the amount that can be claimed.

Purchasers need to be aware of the potential for a mismatch between the representations and warranties being offered by the seller and those which a purchaser will be required to give to its financiers or securitisation investors. In addition, purchasers should give careful consideration to the disclosure that securitisation documents will likely require as a result of recent regulatory changes.

During the period between the cut-off date and completion, the loans remain on the seller's balance sheet. However, purchasers should be economically entitled to all asset collections on or after the cut-off date. Pre-completion collections received by the seller on or after the cut-off date should be deducted from the purchase price.

The timing of loan portfolio sales also depends on whether bidders intend to purchase the existing servicing platform alongside the loans, migrate individual loans to an existing platform, or delegate servicing to the seller or a third party. Interim servicing arrangements with the seller may be necessary until full migration can take place.

Regulation (EU) 2017/2402 (the Securitisation Regulation) provides a set of common requirements regarding risk retention, due diligence, credit granting and disclosure in connection with securitisation positions issued on or after 1 January 2019. These requirements also apply to the warehouse and securitisation financing of loan portfolio sales.

Under Art 9 of the Securitisation Regulation, market participants must ensure that the securitised assets were originated according to the same sound and well-defined credit granting criteria as the criteria applied to similar, non-securitised assets. If the seller purchased loans from a third party, the seller must verify that the original lender satisfied the same credit granting requirements.

Article 6 of the Securitisation Regulation states that assets must not be selected for transfer to the SPV with the aim of rendering losses on them. A regulator may impose sanctions if it finds evidence of an intention to "reverse cherry-pick" assets and if the relative performance of the transferred assets is significantly lower than comparable assets held on the originator's balance sheet during the life of the transaction (up to a maximum of four years).

Despite some recent regulatory headwinds, market activity in this sector remains robust in Europe. Sellers looking to dispose of loan portfolios by way of securitisation should take care to ensure that the transaction complies with the Securitisation Regulation if there is a sufficient EU nexus. However, for many sellers this method of disposing of loan portfolios is worth the effort, since securitisation can result in higher sales proceeds, compared with private portfolio sales. ■

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