New EU Securitisation Regulation

Impact on Luxembourg structures

January 2018

In brief

On 28 December 2017, the long expected Securitisation Regulation (the "Regulation") has been published in the Official Journal of the European Union as Regulation (EU) 2017/2402. The Regulation will expand requirements for banks from the CRR, like Due Diligence and risk retention, also to other institutional investors. However, not all Luxembourg Securitisation vehicles will be affected by the Regulation.

What is it about?

The Regulation entered into force on 17 January 2018 and becomes applicable to securitisation transactions as from 1 January 2019; certain grandfathering rules apply. This Regulation is a key element of the European Commission's Capital Markets Union ("CMU") and shall support the development of the European securitisation market. The purpose is to promote securitisation as an important element of well-functioning financial markets, to diversify funding sources, allocate risk more widely and free up originators' balance sheets to allow for further lending to the real economy.

In its **general part**, the Regulation defines securitisation and establishes, among others, due-diligence, risk-retention and transparency requirements for all parties involved in securitisations, be it banks or other financial markets participants. In addition, it also creates a **specific framework** for simple, transparent and standardised ("STS") securitisation. In the context of the Regulation, the term "Securitisation" is to be understood as a transaction or scheme, whereby a credit risk is tranched:

Securitisation (EU) =		
Credit risk	***&***	***Tranching***
Securitisation of non-recourse credit risk associated with underlying exposure(s) upon whose performance the payments in the transaction or scheme exclusively depend		Securities issued in tranches with subordination that determines the distribution of losses during the ongoing life of the transaction

In addition, the transaction shall not constitute a specialised lending to finance or operate physical assets. Furthermore, under the Regulation, re-securitisation is basically prohibited.

The European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA) have published draft consultation papers on several aspects of the Regulation in order to specify them in detail and give further guidance.

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To whom it applies

The European Union aims to streamline the legislative framework and combine the current sectoral legislations on securitisation in one single regulation. As such, the Regulation applies to institutional investors and to originators, sponsors, original lenders and securitisation special purpose entities ("SSPE").

An **Institutional Investor** covered by the Regulation may be:

- an insurance or a reinsurance undertaking;
- an institution for occupational retirement provision;
- an alternative investment fund manager (AIFM);
- an undertaking for the collective investment in transferable securities (UCITS) if internally managed or otherwise its management company;
- a credit institution; or an investment firm.

The role of a Sponsor in the meaning of the Regulation is limited to credit institutions and investment firms. On the other hand, any entity pursuing the defined activity can act as Originator or Original Lender.

General framework: key requirements

1) Due-diligence

Institutional Investors have to verify certain elements of the transaction, e.g.:

- the credit-granting process of the originator (except if EU credit institutions or investment firms);
- the compliance of originator/sponsor/original lender with risk retention requirements;
- the regular provision of required information by originator/sponsor/SSPE); and
- risks characteristics and structural features pursuant to written procedures (initially and on an ongoing basis).

2) Risk retention

In order to align theirs interests with the ones of the investors:

- either Originator, Sponsor or Original Lender shall retain a material net economic interest in the securitisation on an ongoing basis;
- the material net economic interest shall be not less than 5 %, based on notional value at origination and not subject to any credit-risk mitigation or hedging;
- only one of the parties shall retain the material net economic interest (i.e., no split) and, if no agreement reached between the parties, the originator shall fulfil the risk retention obligation.

3) Transparency

Originator, Sponsor and SSPE have to amongst others:

- provide the (potential) investors on a regular basis with sufficient information, e.g. on the underlying exposure and documentation;
- designate who among themselves will provide the required information;
- make available this information via the securitisation repository (as foreseen by the Regulation) to provide the investors with a single and supervised source of the data necessary for performing their due diligence (except for private securitisations).

Specific framework: "STS" classification

1) STS criteria

With the specific framework of the Regulation, the European Union wants to establish a more risk-sensitive prudential framework for simple, transparent and standardised ('STS') securitisations.

In order to be considered as STS, a securitisation must fulfil numerous criteria divided in simplicity, transparency and standardisation:

Simplicity	Transparency	Standardisation
Portfolio and cash flows	**Investor data availability**	**Structural elements**
• True sale only • No active management (eligibility criteria) • Homogeneous asset type • No re-securitisation • No defaulted exposures • Cash flows not substantially dependent on sale of asset • At least one payment made • ...	• Historical (≥5yrs) default and loss performance data • Sample of exposure independently verified • Liability cash flow model linked to exposure • Originator and sponsor responsible for transparency (incl. STS notification and quarterly investor reporting) • ...	• Risk retention satisfied by originator, sponsor original lender • Interest and currency risk mitigated • Roles and responsibilities of transaction parties, esp. servicer, clearly described • Remedies and actions in case of delinquency/default of debtors or conflicts of investors predefined • ...

This does not mean that a STS securitisation position is free of risks, nor does it indicate anything about the credit quality underlying the securitisation. Nevertheless, it indicates that a prudent and diligent investor will be able to analyse the risks involved in the securitisation.

Securitisation securities, issued before 1 January 2019 may use the STS designation if the STS requirements are complied with at the time of issuance and of notification.

2) Additional requirements

In addition to fulfilling the above indicated STS criteria:

- Originator, Sponsor and SSPE (i.e. the securitisation vehicle) must be established in the European Union;
- all STS must be published in a list on the official website of the ESMA;
- Originators and Sponsors shall jointly notify ESMA of the new STS securitisation and to verify the level of compliance of the STS criteria.

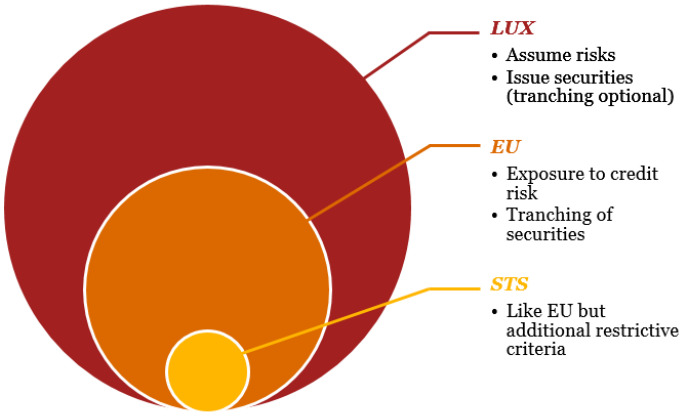
3) Third party verification

Originator, Sponsor and SSPE may use the service of an authorised third party to check whether a securitisation complies with the STS criteria. However, the use of such a service shall not under any circumstances affect the liability of the Originator, Sponsor or SSPE in respect of their legal obligations under the Regulation nor the due-diligence obligations imposed on Institutional Investors.

Impact on Luxembourg structures

Looking at the broad securitisation definition in the Luxembourg Securitisation Law of 22 March 2004, not all Luxembourg securitisation transactions meet the definition of a securitisation as per the Regulation and therefore the Regulation may not apply to all Luxembourg securitisations. Luxembourg securitisations are not restricted to acquire credit risk and do not have to issue several tranches of securities. Thus, a Luxembourg securitisation vehicle may be structured in three possible ways:

The Luxembourg Securitisation Law provides very wide definition



LUX-only Securitisation	EU Securitisation	STS Securitisation
Subject to Luxembourg Securitisation Law but out of scope of the Regulation; by either securitising a risk other than credit risk or by not tranching the securities issued. For regulatory purposes potentially rather treated similar to a corporate bond than securitisation. This may incur different (regulatory) treatment for investors and less obligations for originator and sponsor as would be prescribed by the Regulation.	Securitises credit risk and issues tranched, subordinated securities. May also be subject to Luxembourg Securitisation Law. This would imply that the requirements mentioned above (e.g. risk retention, transparency, due diligence) need to be complied with.	Fulfils the definition of EU Securitisation, i.e. securitises credit risk and issues tranched, subordinated securities. It may also be subject to Luxembourg Securitisation Law but does not have to. In addition, the STS criteria mentioned above need to be complied with.

As such, Luxembourg remains a very flexible and attractive environment, providing legal certainty and an interesting product toolbox. In addition, Luxembourg Securitisation Law allows for the creation of compartments or sub-funds under one legal entity. It has to be seen how the possibility to create multi-compartments will interact with the STS and EU Securitisation classification.

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