

## Securitisation Regulation: Impact on AIFM and UCITS management company investors

Introduced as part of the European Commission's capital markets union action plan, the EU Securitisation Regulation<sup>1</sup> repeals and strengthens the existing requirements on securitisations which currently appear in sector-specific legislation. The Securitisation Regulation establishes and consolidates due diligence, risk retention and transparency requirements relating to securitisation and introduces new rules relating to the issue of simple, transparent and standardised (STS) transactions. It also amends existing EU legislation, including the UCITS Directive and the Alternative Investment Fund Managers Directive (AIFMD) to ensure a level playing field in the internal market for institutional investors. The Securitisation Regulation comes into effect on 1 January 2019. In this briefing, we consider the new regime as it applies to Alternative Investment Fund Managers (AIFMs) and UCITS Management Companies (ManCos) investing in securitisations on behalf of their funds.

### What is an in-scope securitisation?

The definition of "securitisation" is broad. It applies to structures traditionally seen as securitisations, however, it could also include other structures which may not be "commercially" considered a securitisation but have the relevant characteristics.

A securitisation is a transaction or scheme, under which the credit risk associated with an exposure or a pool of exposures is tranching and:

- payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures;
- the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme; and
- the transaction or scheme does not create specialised lending exposures (that is, those possessing all of the characteristics listed in Article 147(8) of the Capital Requirements Regulation (Regulation (EU) No 575/2013)).

### Who does the Securitisation Regulation apply to?

The Regulation applies to institutional investors (the definition of which includes AIFMs (EU and non-EU)<sup>2</sup>, UCITS ManCos and internally managed UCITS<sup>3</sup>) that have an exposure to a securitisation, originators, sponsors, original lenders and securitisation special purpose entities. However, the term "exposure" is not defined in the Securitisation Regulation. While it is often clear that an exposure to a securitisation is held, this uncomfortably leaves open the

question as to when an investor has an "exposure" to a securitisation which may be held indirectly and the extent to which "look through" is necessary. This may be subject to national interpretation or subsequent guidance from the European Supervisory Authorities (ESAs).

### What is changing for AIFMs?

Full-scope AIFMs are already subject to securitisation retention provisions under the AIFMD Level 2 Delegated Regulation<sup>4</sup>. However, the Securitisation Regulation amends some of these requirements and applies to a wider catchment of AIFMs than the existing securitisation provisions. The Securitisation Regulation's definition of "institutional investor" encompasses all AIFMs that manage and / or market AIFs in the EU thereby extending the application of the securitisation retention provisions and due diligence obligations to all AIFMs (regardless of the exemptions in Article 3 of the AIFMD), including non-EU AIFMs which manage and / or market AIFs into the EU and sub-threshold AIFMs that have not opted in to the full application of the AIFMD.

In addition, there is some debate around the strict wording of the definition of AIFM which could bring within the scope of the Securitisation Regulation all AIFs of a non-EU AIFM where it manages or markets only one AIF in the EU. This is possibly an unintended consequence and it is hoped that the issue will be clarified by the ESAs in Level 3 guidance soon. The favourable interpretation is that the securitisation provisions should apply to the AIF which a non-EU AIFM manages and / or markets in the EU only. The alternative would seem unreasonably far-reaching and raises issues regarding enforceability against non-EU AIFMs.

### What is changing for UCITS ManCos?

The provisions under the UCITS Directive for securitisations were never brought into force. Therefore, the Securitisation Regulation brings UCITS ManCos and self-managed UCITS into the scope of the provisions which have applied to full-scope AIFMs for the first time.

<sup>1</sup> Regulation (EU) 2017/2402.

<sup>2</sup> An AIFM as defined in Article 4(1)(b) of the AIFMD.

<sup>3</sup> As defined in Article 2(1)(b) of the UCITS Directive 2009/65/EC.

<sup>4</sup> Regulation (EU) 231/2013, Section 5.

### What are the due diligence requirements prior to holding a securitisation position?

Broadly<sup>5</sup>, the due diligence requirements for institutional investors require managers, prior to holding a securitisation position to verify that<sup>6</sup>:

- unless the originator or original lender is an EU credit institution or investment firm, an EU originator or original lender:
  - grants all the credits giving rise to the underlying exposures on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits; and
  - has effective systems in place to apply those criteria and processes to ensure that credit-granting is based on a thorough assessment of the obligor's creditworthiness in compliance with the Securitisation Regulation<sup>7</sup>;
- if the originator or original lender is established in a third country, the originator or original lender:
  - grants all the credits giving rise to the underlying exposures on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits; and
  - has effective systems in place to apply those criteria and processes to ensure that credit-granting is based on a thorough assessment of the obligor's creditworthiness;
- subject to limited exemptions, the originator, sponsor or original lender (wherever established) retains, on an ongoing basis, a material net economic interest (not to be less than five per cent)<sup>8</sup> and the risk retention is disclosed to the institutional investor<sup>9</sup>; and
- the originator, sponsor or securitisation special purpose entity (SSPE) has, where applicable, made available the information required of it under Article 7 of the Securitisation Regulation (transparency requirements).

<sup>5</sup> There are different provisions relating to asset-backed commercial paper (ABCP) programmes.

<sup>6</sup> Article 5 of the Securitisation Regulation.

<sup>7</sup> In accordance with Article 9(1) of the Securitisation Regulation.

<sup>8</sup> In accordance with Article 6 of the Securitisation Regulation. Article 17 of the AIFMD Level 2 Delegated Regulation currently requires a net economic interest of not less than five per cent.

<sup>9</sup> In accordance with Article 7 of the Securitisation Regulation.

In addition, an AIFM or UCITS ManCo is required to assess the risks involved in holding the securitisation position by carrying out a due diligence assessment to include at least:

- the risk characteristics of the individual securitisation position and of the underlying exposures;
- all the structural features of the securitisation which could materially impact the performance of the securitisation position<sup>10</sup>; and
- for a securitisation notified as STS<sup>11</sup>, the compliance of that securitisation with the requirements in the Securitisation Regulation.<sup>12</sup> AIFMs and UCITS ManCos may rely "to an appropriate extent" on the STS notification made under the Regulation and on the information disclosed by the originator, sponsor and SSPE on the compliance with the STS requirements, "without solely or mechanistically relying on that notification or information". This implies that some additional due diligence is necessary on the part of the manager.

The disclosure requirements on the originator, sponsor and SSPE, and disclosure templates, are detailed in draft technical standards which are being considered by the European Commission<sup>13</sup>. The Securitisation Regulation does not explicitly state that the extent of due diligence required of an investor includes ensuring the originator, sponsor or SSPE have complied with their own transparency requirements. However, an investor should satisfy its own due diligence requirements, for example, to consider the risk and key structural features of the securitisation, by reasonably evaluating the content of required disclosures.

<sup>10</sup> This should include (but not limited to) the contractual priorities of payment and priority of payment-related triggers, credit enhancements, liquidity enhancements, market value triggers and transaction-specific definitions of default.

<sup>11</sup> In accordance with Article 27 of the Securitisation Regulation.

<sup>12</sup> Specified in Articles 19 to 22 or in Articles 23 to 26, and Article 27.

<sup>13</sup> European Securities and Markets Authority (ESMA) Final Report: Technical standards on disclosure requirements under the Securitisation Regulation (ESMA33-128-474).

### What are the due diligence requirements once holding a securitisation position?

Once holding a securitisation position, generally<sup>14</sup>, an AIFM or UCITS ManCo must at least:

- ensure, as discussed above, that the originator, sponsor or original lender retains a material net economic interest of not less than five per cent;
- establish appropriate written procedures proportionate to the risk profile of the securitisation position to monitor, on an ongoing basis, compliance with the due diligence requirements described above and the performance of the securitisation position and of the underlying exposures;
- perform regular stress tests on the cash flows and collateral values supporting the underlying exposures or, in the absence of sufficient data on cash flows and collateral values, stress tests on loss assumptions, having regard to the nature, scale and complexity of the risk of the securitisation position;
- ensure internal reporting to the AIFM or UCITS ManCo management body so that the management body is aware of and adequately manages the material risks arising from the securitisation position; and
- be able to demonstrate to its competent authority, on request, that it has:
  - a comprehensive and thorough understanding of the securitisation position and its underlying exposures; and
  - it has implemented written policies and procedures for the risk management of the securitisation position and for maintaining records of the verifications, due diligence and of any other relevant information.

Where an institutional investor has given another institutional investor, such as a delegate investment manager (the Managing Party), authority to make investment management decisions that might expose it to a securitisation, the institutional investor may instruct the Managing Party to fulfil its obligations in respect of any exposure to a securitisation arising from those decisions. In such a case, Member States must ensure that any sanctions for breaches of the requirements are imposed on the Managing Party and not on the institutional investor.

### Written procedures

Where relevant with respect to the securitisation and the underlying exposures, written procedures shall include:

- monitoring of the exposure type;
- the percentage of loans more than 30, 60 and 90 days past due;
- default rates;
- prepayment rates;
- loans in foreclosure;
- recovery rates;
- repurchases;
- loan modifications;
- payment holidays;
- collateral type and occupancy and frequency distribution of credit scores or other measures of credit worthiness across underlying exposures;
- industry and geographical diversification;
- frequency distribution of loan to value ratios with band widths that facilitate adequate sensitivity analysis; and
- where the underlying exposures are themselves securitisation positions, the exposures underlying those positions.

### What about corrective action?

The Securitisation Regulation amends the AIFMD and UCITS Directive to provide that, where such managers are exposed to a securitisation which no longer meets the requirements in the Regulation, they shall "in the best interests of the investor in the relevant [AIFs / UCITS] act and take corrective action, if appropriate".<sup>15</sup> This does not seem overly different from the existing provision in the AIFMD Level 2 Delegated Regulation, which clarifies in its recitals that such corrective action does not necessarily require the disposal of the position:

*"In case of a breach of the retention requirement or the qualitative requirements the AIFM should consider taking some corrective action, such as hedging, selling or reducing the exposure or approaching the party in breach of the retention requirement with a view to reinstating compliance. Such corrective action should always be in the interest of the investors and should not involve any*

<sup>14</sup> There are additional provisions relating to ABCP programmes

<sup>15</sup> Amended Article 17 of the AIFMD and Article 50a of the UCITS Directive.

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*direct obligation to sell the assets immediately after the breach has become apparent, therefore avoiding a 'fire sale'. The AIFM should take the breach into account when considering making another investment in a further transaction in which the party in breach of the requirement is involved.*<sup>16</sup>

### Are there any transitional provisions?

The obligations on institutional investors under the Securitisation Regulation applies to new securities issued on or after 1 January 2019 which relate to securitisations. However, for AIFMs that were already required to apply the due diligence and risk retention requirements under the AIFMD, these continue to apply for:

- any securities relating to securitisations issued on or after 1 January 2011 but before 1 January 2019; and
- any securities relating to securitisation issued before 1 January 2011 where new underlying exposures have been added or substituted after 31 December 2014.

### What's next?

The FCA has consulted on its Handbook changes necessary as a result of the Securitisation Regulation<sup>17</sup> and intends on publishing its final rules in a policy statement in December 2018. The changes consulted on are consistent with the Regulation.

### What should managers do now?

- UCITS ManCos, sub-threshold and non-EU AIFMs should consider the holdings of the funds they manage to establish if they hold securitisations. Separately, identify any non-EU securitisations which may require additional steps to obtain the requisite information.

- Existing full-scope AIFMs should review existing AIFMD-compliant investment processes to ensure compliance with the new regime.
- New in-scope managers should draft policies and procedures ready to implement the new obligations.
- Ensure record-keeping complies with the necessary requirements.
- Consider relevant delegation arrangements to make sure the manager's obligations under the Securitisation Regulation are adequately satisfied by the delegate if necessary.
- All stakeholders should consider relevant consultations and publications relating to rules and regulations under this regime.

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<sup>16</sup> Recital (69) of Regulation (EU) 231/2013.

<sup>17</sup> FCA CP 18/22.

**November 2018**

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