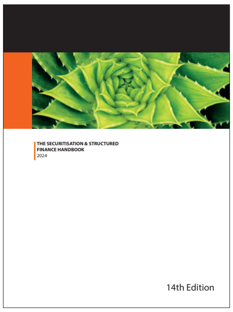
THE SECURITISATION & STRUCTURED FINANCE HANDBOOK
2024

14th Edition



The Securitisation & Structured Finance Handbook 2024

14th Edition

CONTRIBUTORS

Allen & Overy LLP
Asia Pacific Structured Finance Association (APSA)
Association for Financial Markets in Europe (AFME)
Clifford Chance
DG FISMA (European Commission)
GSK Stockmann
Hogan Lovells LLP
Information Management Network (IMN)
Prime Collateralised Securities (PCS)
Reed Smith LLP
Structured Finance Association (SFA)
Viera de Almeida Advogados (VdA)
Walder Wyss AG
Wolf Theiss Rechtsanwalte

Editor: Michelle Hallworth
Editorial Research: Sterling Morrison
Associate Publisher: David Hancock
Publisher: Adrian Hornbrook
Editorial Office:
35 North Hill, Colchester, Essex CO1 1QR, UK
Tel: +44 1206 579591
Email: michelle@capintelligence.co.uk
Website: www.capital-markets-intelligence.com
Origination by: Foreland Creative, Margate, Kent CT9 3LR, UK
Printing by: Knockout Print, Matfield, Kent TN12 7LP, UK

Contents

Securitisation—financing decarbonisation

By Elen Callahan and Jessica Steele, Structured Finance Association

SIGNIFICANT CARBON TRANSITIONS WITHIN THE ENERGY SECTOR ARE CRITICAL TO DECARBONISATION AND THE SHIFT TOWARDS SUSTAINABLE ENERGY. SECURING ADEQUATE FINANCING THROUGH SUCH TOOLS AS SECURITISATION IS CRUCIAL TO ADDRESSING TRANSITION COST AND DRIVING THE PROCESS OF DECARBONISATION EFFECTIVELY.

In the United States, a focus on cleaner energy production and the imperative to enhance infrastructure reliability is projected to stimulate capital expenditure in the coming years. At the federal level, the Inflation Reduction Act (IRA)[1], which was enacted in August 2022, is expected to have a significant impact in this regard by introducing ten-year extensions for both the investment and production tax credits associated with wind and solar energy and by providing a distinct tax credit aimed at battery storage.

Elen Callahan

Jessica Steele

Elen Callahan
Head of Research & Education
elen.callahan@structuredfinance.org

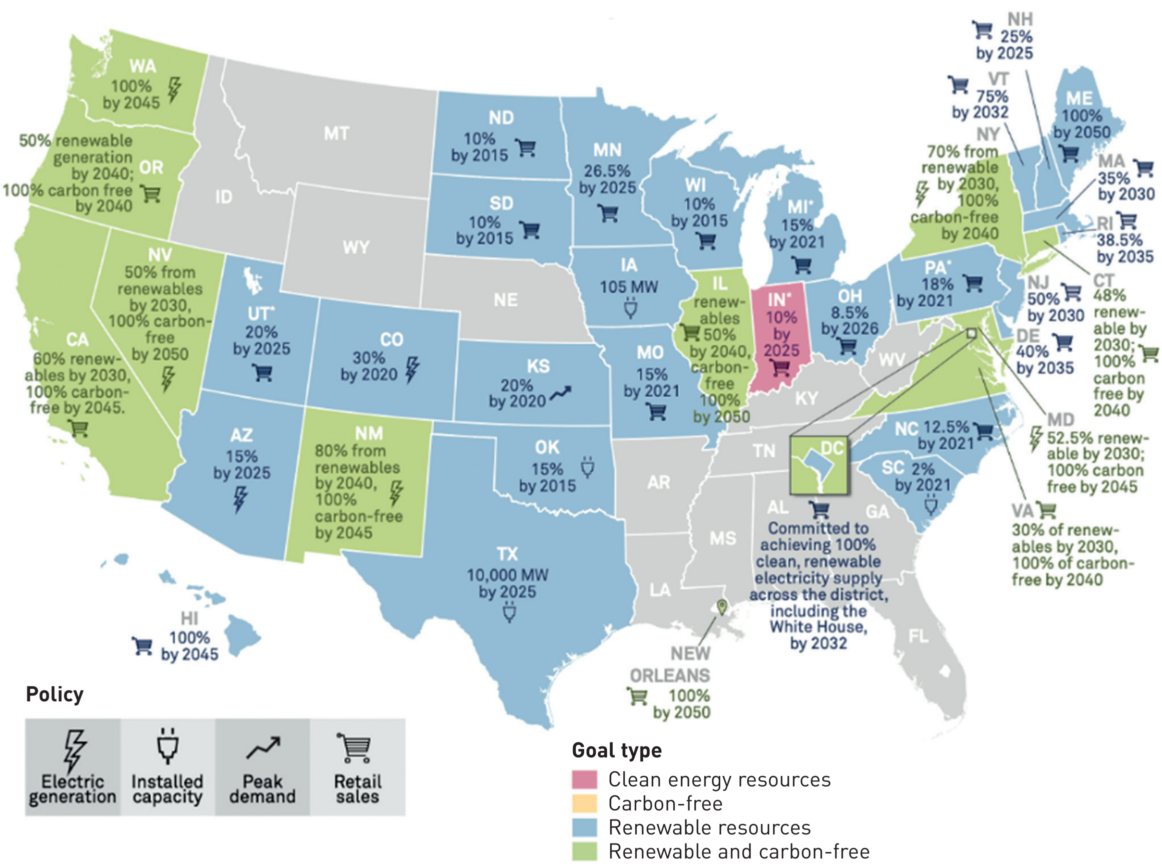
Jessica Steele
Associate, Research
jessica.steele@structuredfinance.org

Carbon transition initiatives involve the development of renewable energy projects, energy efficiency improvements, and other sustainable innovations. While the IRA furnishes incentives, it refrains from mandating that states attain specific outcomes. Indeed, over the past 10 years, many states have been formulating distinct agendas to guide their energy transition efforts. In recent years, 36 states[2] have enacted renewable and clean energy goals, with many addressing the associated transition cost through subnational decarbonisation legislation.

At the federal and state level, decarbonisation transition is taking place in three areas – energy production, transportation, and built spaces.

In energy production, securitisation has previously been employed to finance stranded costs but is increasingly being used to fund carbon transition cost. In the 1990s, when many states deregulated their electricity markets to promote competition and reduce costs, public utility firms found themselves with transition costs associated with

State renewable and clean energy goals **Exhibit 1**

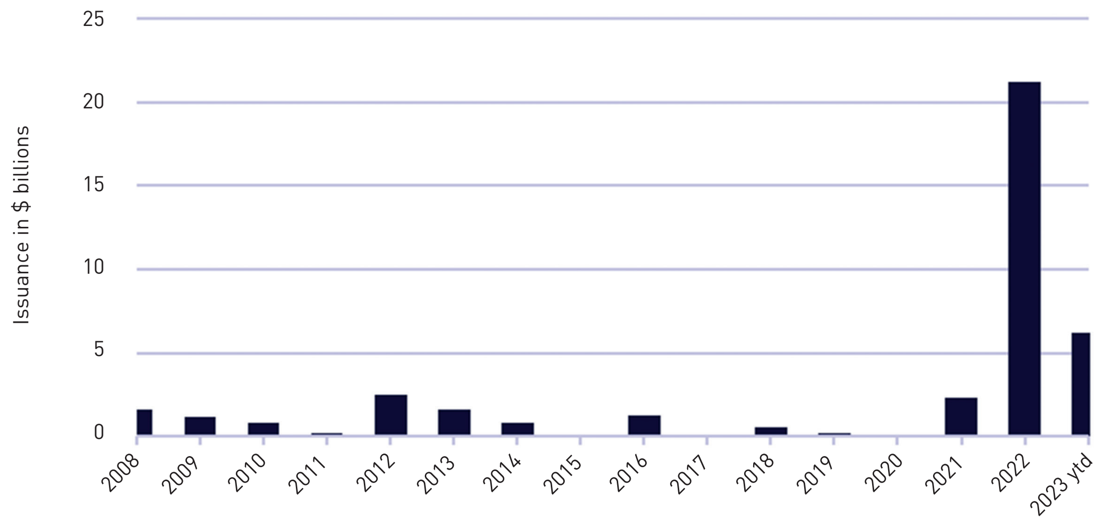


Note: As of May 19, 2022. Map credit: Joe Felizadio. Source: Regulatory Research Associates, a group within S&P Global Commodity Insights. © 2022 S&P Global.

decommissioned facilities or phased out operations that were no longer economically viable under the new competitive landscape. Households served by the utilities paid additional monthly surcharges until these costs were recovered. Issuing bonds—Stranded Cost ABS—with these future payments as the collateral, reduces the impact on the utilities' customers (ratepayers) of these stranded costs. By allowing utilities to raise funds at a lower borrowing rate than traditional financing, and often over longer time periods, securitisation not only helps the utility maintain financial stability without a break in service, but also more importantly absorbs some of the short-term rate shocks that would otherwise be a strain for most retail customers.

Stranded Cost ABS, also known as Rate Reduction Bonds (RRBs), later became a model for utilities to recover extraordinary expenses arising from catastrophic weather events and natural calamities, where the costs are passed through to the consumers. RRBs were used extensively to ease the pain of wildfires in California (2017) and of severe winter storms in the south (2021), creating issuance in 2022 that was 22 times greater than the average level of the past 14 years. Now RRBs are being used to recover or

Rate reduction bonds – Issuance 2008-2023 ytd **Exhibit 2**



Source: Finsight

reduce expenses associated with the states' transition towards sustainable energy sources and, specifically, to retire coal plants.

The process consists of three key components: state-level legislation authorising the use of securitisation, financing orders authorising utilities to recover costs from ratepayers, and the establishment of specialised entities to facilitate the transaction.

In the initial stage, states empower utilities through legislation to fund cost recovery by enabling securitisation of ratepayer surcharges. The state utility commission then issues an irrevocable financing order, imposing a surcharge on customers within the utility's service area. Finally, the creation of a specialised purpose entity manages the financial aspects of the securitisation, receiving the cost-specific surcharge payments into this entity, which are then used to pay off the bondholders while a separately funded reserve account offers a safeguard against utility defaults. This structure is designed to ensure that ratepayers aren't held responsible for securitisation costs.

21 States where RRB securitisations have been issued 1997-2022 (By purpose)

Disposing of Stranded Costs	Retiring Nuclear/Coal Plants or Clean Energy Investments	Storm Damage and Wildfire Costs	Deferred Balances*/ Other
California, Montana, Illinois, Pennsylvania, Massachusetts, Michigan, Texas, New Jersey, Louisiana, New Hampshire	Wisconsin, West Virginia, Florida, Michigan, Indiana	Texas, Louisiana, Kansas, Oklahoma, Arkansas, North Carolina, and Florida	New Jersey, Maryland, Ohio, West Virginia

***Note: Deferred Balances refer to rate stabilisation plans that defer the effect of market-rate pricing over a period of years as was the case in Maryland. Source: Saber Partners, LLC, Finsight, SFA Compilation.**

According to Finsight, US$6.2bn of RRB issuance came to market in the first half of 2023. This follows a record-setting US$21.2bn of new issuance in 2022, which accounts for 52% of total issuance since 2008. With the overwhelming majority of the RRBs bonds carrying the highest credit rating of triple-A and offering generous spreads relative to similarly rated fixed income investments, investor interest in RRBs has been strong.

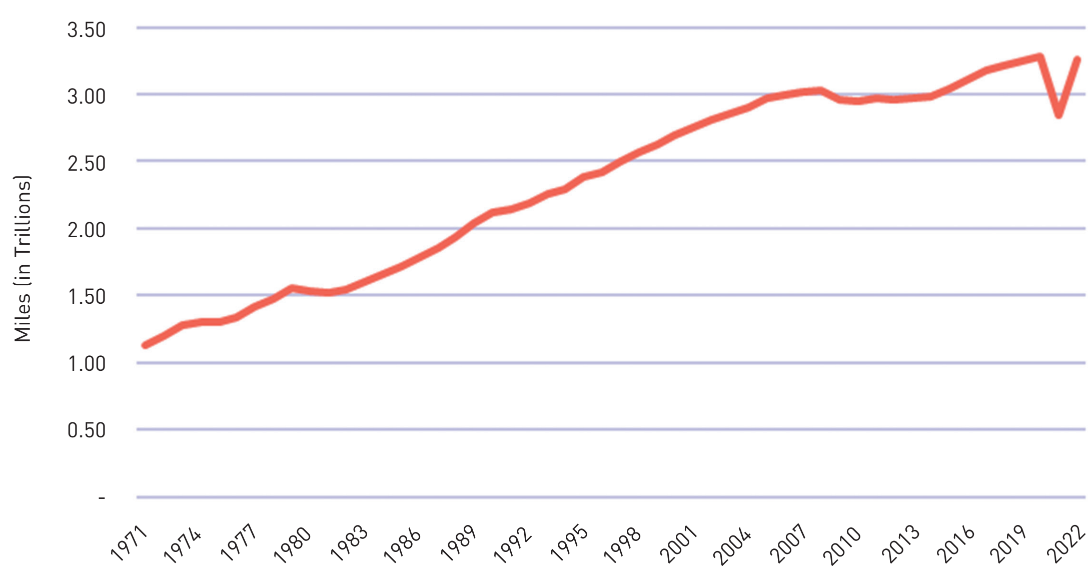
S&P has rated 190 triple-A tranches of RRBs totaling approximately US$26bn. According to S&P, RRBs provide an "increasingly important source of capital for climate solutions as it relates to physical risk, energy transition, and increased demand for electricity." Further, the rating agency continues, "physical risk-related funding needs can include reimbursements of fuel prices, storm and wildfire recovery costs, and grid improvement and restoration.

Examples of energy transition-related financing include carbon plant decommissioning, investments in renewable energy and energy storage projects, and potential costs due to regulatory compliance. Increased demand for electricity continues to prompt further investments in diverse pools of power generation sources, and the management of grid infrastructure, expansion, and resilience." S&P, in their report Non-Traditional ABS Issuance and 2023 Outlook[3], notes that the asset class is "positioned for growth, given the increased frequency of extreme weather events and the need for risk mitigation projects."

Transportation – as the world shifts toward more sustainable options, securitisation can play a role in supporting the transition of the market.

The transportation sector, both personal transportation and transportation of cargo combined, is the largest source of greenhouse gas (GHGs) emissions in the US,

Annual vehicle miles travelled (VMT) 1971-2022 **Exhibit 3**



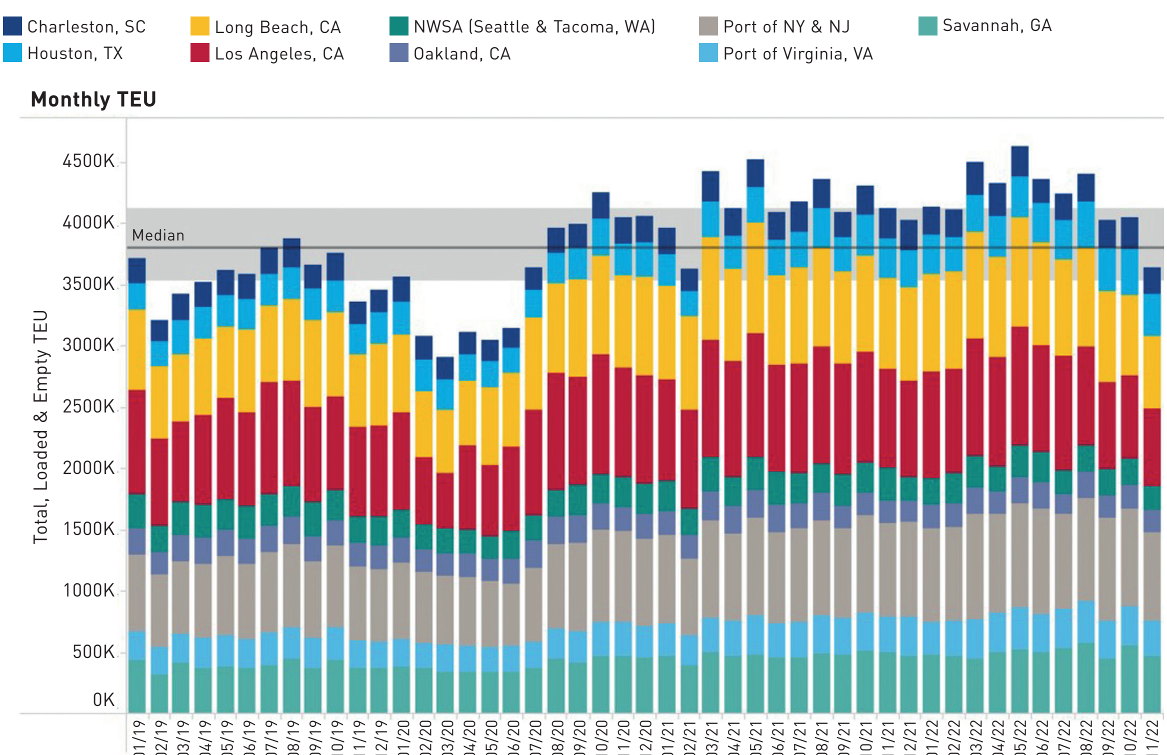
Source: Alternative Fuels Data Center, U.S. Dept. of Energy, from U.S. Federal Highway Administration monthly data.

contributing 29%[4] of all emissions. Within the transportation sector, light-duty vehicles represent 58%[5] of emissions from the sector. Put another way, in the US more than half of GHG's in the largest emitting sector come from our personal vehicles. Unlike some sectors that have seen emissions decrease over time, transportation GHG emissions have been increasing and are now 24% higher than in 1990 despite significant improvements in fuel efficiency and emissions in response to a steady tightening of regulatory standards in this class of vehicles.

For example, miles per gallon (mpg) standards have more than tripled (from 13.75mpg to the current 43.3mpg) since 1975, when the first federal Corporate Average Fuel Economy (CAFE)[6] standards were established. On real-world CO2 emissions, the Environmental Protection Agency's (EPA's) 2022 Automotive Trends[7] report shows that fuel economy for new model 2022 vehicles is at the highest level recorded since 2004. However, outpacing these efficiencies has been a sharp increase[8] in the total vehicle miles traveled (VMT),with national annual totals that pushed past 3 trillion in 2018 and, post-COVID, have resumed their track. This, coupled with the steady shift of consumer preference toward less efficient SUVs and away from sedans, which now hold only 26% of the new vehicle market in this class, has expanded overall GHG emissions, pushing them higher each year.

Currently, there are over US$220bn of auto ABS outstanding in the US Since 2014, US$5.5bn of auto ABS

20-Foot equivalent units (TEU) handled by select US container ports: January 2019 to November 2022 **Exhibit 4**



Source: U.S. Department of Transportation, Maritime

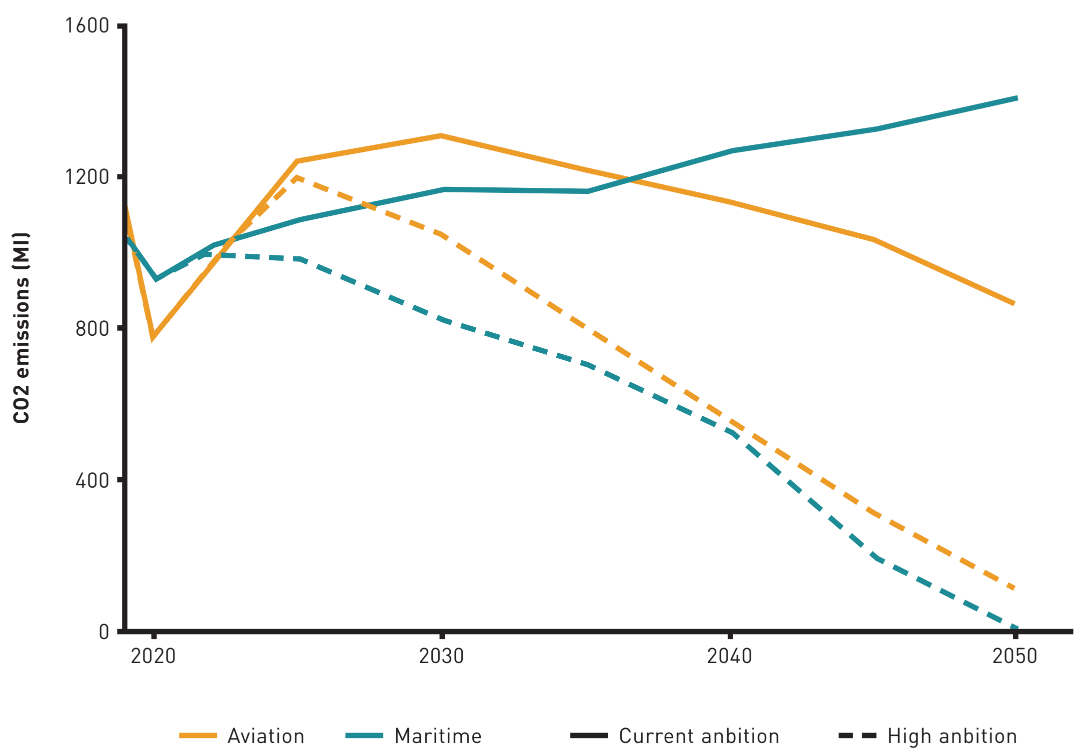
5

has been issued as a labeled Green Bond by a third-party assessor. Responding to investor interest regarding the concentration of hybrid and EV vehicles in a securitisation that does not have a Green label, issuers of Auto ABS have begun to make this information available. As the transition to Green technology carries with it residual value risk due to technological obsolescence, investors' analyses considers the impact on vehicle valuation as it relates to default, recovery, and loss performance of an auto ABS.

Transportation of cargo, the other large component of transportation GHGs, includes ship, rail, and trucks, all of which carry cargo in containers. Shipping containers have transformed the freight transport industry, resulting in improved efficiencies and economies of scale. Container leasing companies, which own 50% of the containers in circulation, have been relying on the securitisation market for funding since the 1990s as investors see in this asset class a way to diversify away from consumer debt. There are currently US$13.5bn of container ABS outstanding, according to S&P Global[9], of which US$12.7bn is rated single-A.

Sea freight plays a pivotal role in both global trade – carrying 80% of all traded goods by volume, or 70% by value – and in carbon transition. The Organization for Economic Co-operation and Development (OECD) tracks the trends in global transport through their International Transport Forum, reporting annually with updated projections for a sustainable transport future. Their

Aviation and maritime freight transport emissions – current and high-ambition scenarios (2019-2050) **Exhibit 5**



Source: OECD ITF Transport Outlook 2023

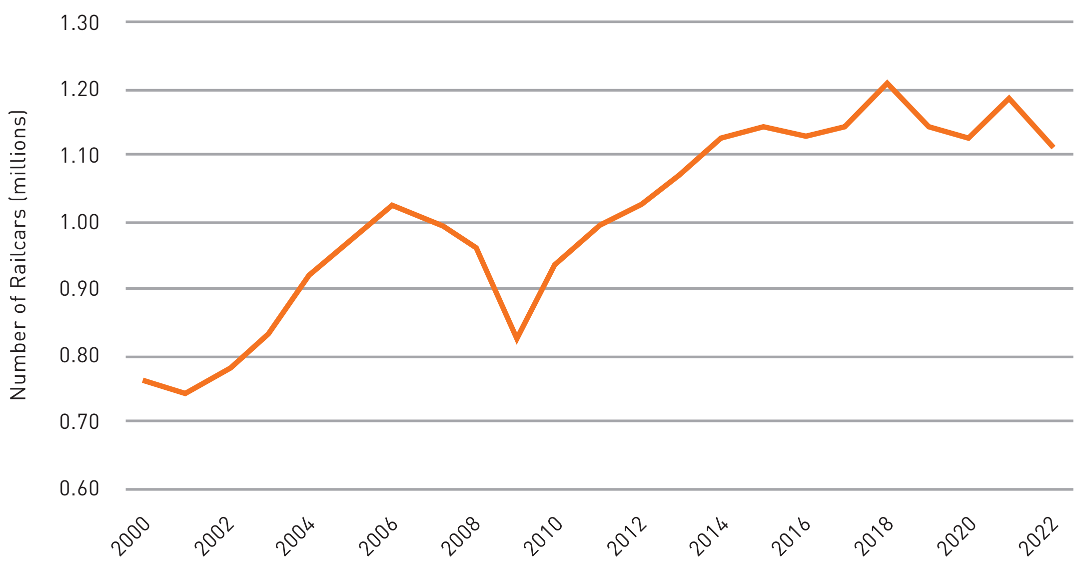
Outlook 2023 report states that, "While the maritime sector does not produce a significant share of global passenger emissions, it accounted for 29% of freight emissions in 2019." Shipping contributes 3% of the world's greenhouse gas emissions, or put another way, "if shipping were a country, it would be the world's sixth biggest greenhouse gas emitter."[10]

The steady increase in volume of global freight shipping is expected to lead to a 35% increase in emissions from maritime freight under the 'Current Ambition' scenario. Due to the long distances involved, decarbonisation is expected to rely on "large-scale adoption of alternative low-carbon fuels."

On July 7, the International Maritime Organization (IMO), the United Nations agency responsible for both improving the safety and security of international shipping and for preventing pollution from ships, adopted a revised strategy[11] to reduce ships' CO2 emissions. Goals include a net-zero emissions target by 2050, with interim targets of 37% emissions cut by 2030 and 96% by 2040. This is an important step toward decarbonising the footprint of shipping transportation, of which the merchant fleet – oil tankers, bulk carriers, general cargo, and container ships – is a large part.

The maritime freight industry has been moving towards decarbonisation by improving efficiencies and exploring innovation in fuels. Since 2008, the industry has been practicing slow steaming, the reduction of speed to improve fuel efficiency, albeit while slowing delivery times. The practice was formally adopted by the International Maritime Organization (IMO) in 2011. Shipping customers facing pressures to curb Scope 3 emissions have been driving these efforts – 71% of respondents to a 2021 BCG Shipping Decarbonisation Survey[12] said they are willing to pay a 2% premium, on average, for carbon-neutral

Rail freight intermodal traffic (2000-2022) **Exhibit 6**



Source: OECD ITF Transport Outlook 2023

shipping. More recently, French President Macron proposed a tax[13] on the GHGs produced from international shipping. So far, the proposal has garnered the support of 23 countries. The levy, which may raise as much as US$100bn[14] annually, would be the first for the shipping industry and is expected to hasten the industry's efforts to a green transition.

In the US a similar tax was proposed on June 8, World Ocean Day, with the International Maritime Pollution Accountability Act[15] introduced in the US House of Representatives, which would impose a US$150 per ton fee on the carbon emissions of the fuel burned on an inbound vessel as well as fees on nitrogen oxides, sulfur dioxide, and particle pollution. Tighter carbon intensity standards would also be set for fuels used on ships in a separate bill, The Clean Shipping Act[16] of 2023, introduced concurrently in the US Senate.

For the US, shipping is the leading transportation mode for international trade[17], moving US$1.1 trillion (43% of total trade value), two-thirds of which is containerised. But within the US, the freight industry relies more on long-haul trucks and trains. Delivering roughly 40% of US long-distance freight volume, trains are responsible for only 1.7%[18] of transportation related GHG emissions. Railcar freight shipped in containers has increased steadily (excluding recessions) since the 1990s, and lessors have been turning to the ABS market for their funding needs since 2001. According to S&P Global[19], there are US$7.4bn railcar lease ABS outstanding, of which nearly US$7bn is rated single-A. Since 2017, there have been 22 railcar ABS deals with a median size of US$800m. While a much smaller part of the ABS market, with recent upgrades at ports, railcars offer a lower-carbon alternative to long-haul trucking for freight delivery.

Certain sectors, such as manufacturing, mining, construction, agriculture, and wholesale and retail trade, are particularly dependent on freight transport. To the extent that anticipated efficiencies develop and decarbonisation proposals are executed, container ABS could join railcar ABS in facilitating the decarbonisation transition.

Built Spaces—commercial property owners and the transition

Built environments are responsible for 40% of GHG emissions, and two-thirds[20] of the buildings that will be generating those emissions in 2040 are already built today. In the US, Commercial Property-Assessed Clean Energy (C-PACE) loans facilitate the financing of energy efficiency and renewable energy improvements on private property.

Property owners participating in a C-PACE program repay the clean energy improvement's costs over longer repayment periods, typically 10 to 20 years, and at significantly lower interest rates than commercial lending. The loan is secured by the property and paid as an assessment to the owner's tax bill, remaining on the tax assessment of the property in the event of a sale. A failure to pay may result in a property tax lien, which has priority over all other liens, or in a tax sale. Because proceeds from the loans are used to reduce the carbon footprint of the buildings that secure them, C-PACE ABS has been considered by many impact investors as a green investment opportunity. Some transactions add a review of collateral, verifying alignment to the Green Bond Principles[21] (GBP) as defined by the International Capital Market Association (ICMA).

According to Finsight, roughly US$8bn of ABS backed by PACE loans have been issued since 2014 in the 144a market. Approximately 83% of C-PACE loans have financed upgrades to existing structures. But new construction has seen some very impactful C-PACE projects, too. When Washington, D.C.'s Audi Field[22], a 20,000-seat soccer stadium, was first planned in 2018, it included US$25m of C-PACE loans in its US$300m financing stack. The building now boasts a green roof, water consumption reduction measures, and a solar collection system that generates 841kw, enough to power 95 homes.

While PACE ABS is still a very small asset class, hitting US$2bn in issuance in its busiest year, C-PACE originations have picked up in recent years according to a DBRS Morningstar commentary[23], with US$1.3bn and US$1.51bn being recorded in 2021 and 2022, respectively. The report states that C-PACE has "largely remained out of the broader public capital markets activity" and suggests the lack of uniformity between jurisdictions creates a significant stumbling block to wider acceptance of this funding source.

Conclusion

Securitisation can be a powerful financing tool for decarbonisation efforts, especially in the context of transitioning to a more sustainable economy. The Structured Finance Association (SFA) has been tracking regulatory initiatives and its members have been discussing best practices for disclosures of environmental impact data. With investor demand growing for sustainable investment opportunities and the potential for increased supply in energy production, transportation and built spaces, securitisation is well positioned to present a competitive funding source for the decarbonisation transition.

Contact us:

Structured Finance Association

1776 I Street NW

Suite 501

Washington, DC 20006

USA

Tel: +1 202 524-6300

Email: Info@sfindustry.org

Website: www.structuredfinance.org

Notes

1 https://www.whitehouse.gov/wp-content/uploads/2022/12/Inflation-Reduction-Act-Guidebook.pdf
2 https://www.naruc.org/nrri/nrri-activities/clean-energy-tracker/
3 https://www.spglobal.com/ratings/en/research/pdf-articles/230516-slides-u-s-non-traditional-abs-issuance-and-2023-outlook-101576979
4 https://www.epa.gov/greenvehicles/fast-facts-transportation-greenhouse-gas-emissions
5 https://www.epa.gov/greenvehicles/fast-facts-transportation-greenhouse-gas-emissions
6 https://www.epa.gov/greenvehicles/fast-facts-transportation-greenhouse-gas-emissions
7 https://www.epa.gov/automotive-trends
8 https://fred.stlouisfed.org/series/TRFVOLUSM227SFWA
9 https://www.spglobal.com/_assets/documents/ratings/research/101577053.pdf
10 https://www.weforum.org/agenda/2018/04/if-shipping-were-a-country-it-would-be-the-world-s-sixth-biggest-greenhouse-gas-emitter
11 https://www.imo.org/en/MediaCentre/PressBriefings/pages/Revised-GHG-reduction-strategy-for-global-shipping-adopted-.aspx
12 https://www.bcg.com/publications/2021/global-zero-carbon-shipping-transformation-challenge
13 https://m.economictimes.com/small-biz/trade/exports/insights/france-to-push-shipping-carbon-tax-at-finance-summit/articleshow/101096226.cms
14 https://www.reuters.com/breakingviews/shipping-tax-could-yield-100-bln-climate-windfall-2023-06-12/
15 https://www.congress.gov/bill/118th-congress/senate-bill/1920?s=1&r=70
16 https://www.congress.gov/bill/118th-congress/house-bill/4024/text?s=1&r=4
17 https://data.bts.gov/stories/s/Supply-Chain-Challenges/5tut-fj6e
18 https://www.aar.org/facts-figures#:~:text=Freight%20railroads%20account%20for%20roughly,any%20other%20mode%20of%20transportation.
19 https://www.spglobal.com/_assets/documents/ratings/research/101577053.pdf
20 https://architecture2030.org/why-the-built-environment/
21 https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/green-bond-principles-gbp/
22 https://www.newcolumbiasolar.com/projects/audi-field/
23 https://www.dbrsmorningstar.com/research/411391/c-pace-and-cmbs

EU changeover: why securitisation should be a priority in the next political mandate

By Maria Pefkidou and Shaun Baddeley, AFME

The EU Securitisation Framework has not yet fulfilled its purpose of resurrecting the European securitisation market. As the 2019-2024 EU institutional cycle will soon be coming to an end, and the UK is already introducing reforms to the UK securitisation framework, one must take the time to reflect on the progress made so far and the right way forward.

By way of reminder, the revival of the European securitisation market after the Global Financial Crisis ("GFC") was a prominent feature of the Capital Markets Union ("CMU") action plan, an initiative launched by the European Commission ("Commission") in 2015 aiming to reduce reliance on the banking sector and to promote alternative sources of capital and liquidity through the capital markets.[1]

Securitisation, as a capital markets instrument, constituted a core pillar of the CMU. According to the Commission then, if EU securitisations could be revived to pre-crisis average issuance levels, banks would be able to provide an additional amount of credit to the private sector of more than €100bn, and if SME securitisation was re-built to half the crisis peak, it could generate €20bn of additional funding.[2]

The adoption, therefore, of the new securitisation framework, namely the Securitisation Regulation (Regulation (EU) 2017/2402) ("SECR") and the Securitisation Prudential Regulation (Regulation (EU) 2017/2401) ("SPR"), (together the "EU Securitisation Framework"), represented the first important step towards

Maria Pefkidou

Shaun Baddeley

Maria Pefkidou

Manager, Securitisation

Direct: +44 (0) 20 3828 2707

Mobile: +44 (0) 7789 870 120

Email: maria.pefkidou@afme.eu

Shaun Baddeley

Managing Director, Securitisation

Direct: +44 (0) 20 3828 2698

Mobile: +44 (0) 7584 582 759

Email: shaun.baddeley@afme.eu

that goal, and both regulations entered into force on January 1, 2019.

In the current political cycle (2019-2024), securitisation was once again part of the CMU action plan (published in 2020), a key objective of which was to support the green, digital and resilient economic recovery.[3] Scaling up the EU securitisation market was deemed necessary for the post-Covid-19 economic recovery,[4] and as a result the Capital Markets Recovery Package ("CMRP"), which came into force on 9 April 2021, included changes to the SECR too.[5]

Although the EU Securitisation Framework has undoubtedly created an international "gold standard" both for simple, transparent and standardised ("STS") and non-STS securitisations, the market has not yet recovered since the GFC, and several aspects of the regulatory framework require further fine-tuning. If the necessary improvements are not made soon, the EU will risk missing the crucial contribution that securitisation can make towards covering its rising financing needs. For these reasons, as further explained below, it is vital that securitisation remain a central aspect of the next EU legislative cycle (2024-2029) too.[6]

Europe needs well-functioning securitisation now more than ever

The current economic environment poses significant challenges which government funding and bank lending alone cannot tackle sufficiently. The demographic crisis faced by the EU[7] puts pressure on public budgets and state pension systems, while inflation, rising interest rates and the ongoing war in Ukraine trigger another set of problems. In the same time, the green transition requires an enormous amount of funding estimated at €350bn in additional investment per year over this decade for the EU alone to meet the 2030 emissions-reduction target in energy systems, and an additional €130bn for other environmental goals.[8] It will therefore be crucial for all sources of capital and liquidity to be deployed across the full array of financial products.

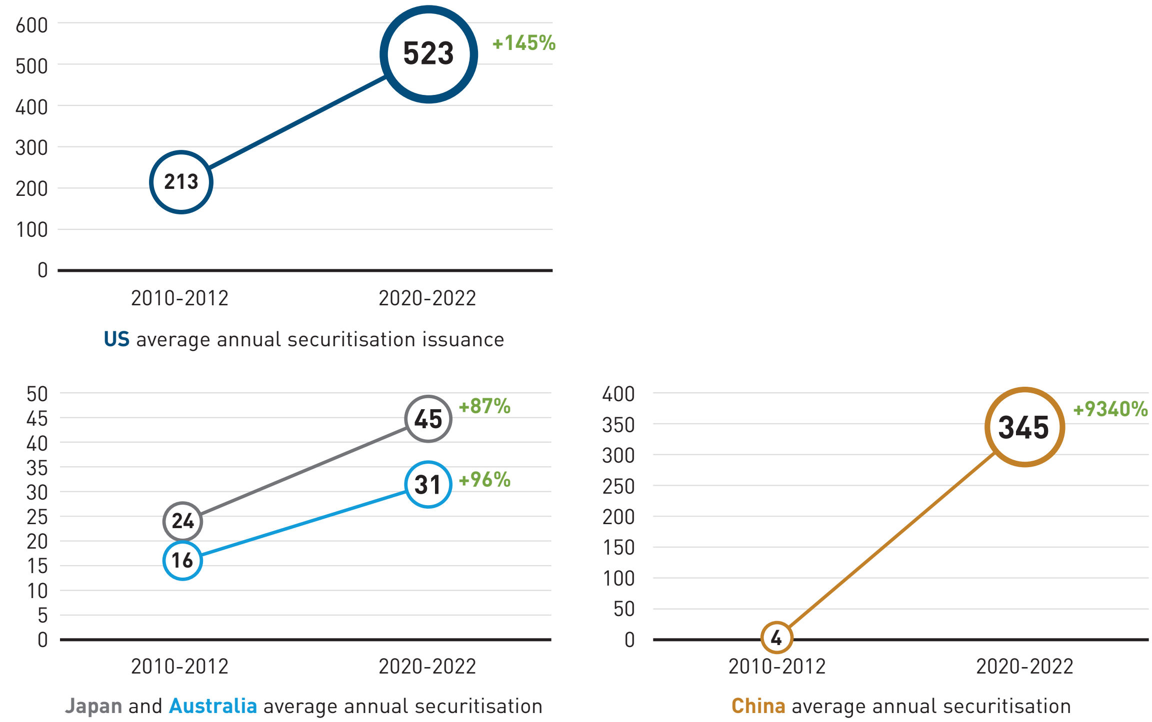
Securitisation is, in fact, perfectly designed to support the European economy, as it acts as a bridge between the banking sector and the capital markets. By using securitisation, banks can not only cover their own funding needs, but they can also free up regulatory capital which generates new lending. They can better absorb upcoming pressures when capital requirements increase, and they can resolve existing Non-Performing Exposure ("NPEs") portfolios by removing them from their balance sheets.

Securitisation can also significantly contribute to the green transition.[9] According to recent research, securitisable green lending could exceed €300bn annually by 2030 in respect of three asset classes alone, namely residential mortgage loans on energy-efficient properties, loans for green home renovations and electric vehicle financing.[10]

However, the European securitisation market (including the UK) has yet to see the growth envisaged by the 2015 CMU action plan. Total issuance – and placed issuance in particular – remains well below pre-GFC levels[11] causing the market to lag far behind other jurisdictions. While in 2008, its size (including the UK) was 75% that of the US, it diminished to only 6% in 2020,[12] a year after the implementation of the EU Securitisation Framework. In the meantime, publicly placed securitisation issuance has grown significantly in the US, Japan, Australia and China.[13] (Please see Exhibit 1 on page 12, "Growth of securitisation issuance in global jurisdictions".)

Green securitisation issuance is even more depressed. As noted by the European Banking Authority ("EBA"), in Q1 2021 securitisation only accounted for 1% of green bonds issuance in the EU, compared to 50% in the US and 11% in China.[14] The difference is equally staggering if one also looks at data from a longer period, namely 2019-2023H1. Green securitisation issuance represents only 1% of total European green issuance, whereas it stands at 5.1% in China and 24.9% in the US.[15] (Please see Exhibit 2 on page 12, "Green securitisation (2019 - 2023H1))". Unsurprisingly, therefore, the Commission's report on the functioning of the SECR[16] published in October 2022 (the "SECR Report") stated that "expectations for a highly dynamic market with increasing volumes and a growing number of participants do not yet seem to have been fulfilled".

Growth of securitisation issuance in global jurisdictions	Exhibit 1



Source: AFME data.

Green securitisation (2019 – 2023H1)	Exhibit 2

Source: AFME data.

The need to revisit aspects of the EU Securitisation Framework

As the European securitisation market remains well below potential, in the next legislative cycle EU policymakers may wish to revisit aspects of the EU Securitisation Framework and make the necessary adjustments. The section below will try to identify those areas while also reflecting on the latest regulatory developments.

On 27 June 2023, negotiations on the CRR3 banking package resulted in a political agreement which included an important mitigating measure for securitisation. The agreement includes (a) transitional measures on the output floor – effective until December 2032 – which lower the p-factor by 50% for both STS and non-STS securitisations for banks using Internal Ratings-Based Approaches ("IRBA") and (b) a review clause which mandates a wider review of the prudential treatment of securitisation by December 2026. The review may then lead the Commission to submit a legislative proposal by December 2027.

Had these measures not been agreed, the impact of the output floor on the market would have been devastating.[17] Corporate securitisations would largely be eliminated and existing transactions done for risk management purposes would likely fail the EU Significant Risk Transfer ("SRT") test and would have to be terminated.[18] SRT securitisation is the main instrument used to share risk and redeploy capital into lending to large corporates, SMEs and project finance, so it is of utmost importance that the negotiations' outcome supports the economic viability of SRT transactions.

As the CRR3 2026 review will fall within the scope of the next political mandate, EU policymakers could use the opportunity not only to further improve the banking framework, but to also make targeted adjustments to the Liquidity Coverage Ratio ("LCR") and the insurance prudential framework, namely Solvency II. Unfortunately, the recent response of the European Supervisory Authorities ("ESAs") to the Commission's call for advice on the review of the securitisation prudential framework concluded that no changes to the LCR and Solvency II are required on the basis that there is no sufficient evidence to prove that the existing frameworks are not fit for purpose.[19]

However, securitisation has a strong track record of liquidity - in many cases better than that of covered bonds[20] – which does not justify its punitive treatment under the LCR.[21] A recent example is the liability driven investment ("LDI") crisis in the UK, which, due to the UK government's "mini-Budget" in September 2022, triggered a forced sell-off in Gilts and caused UK pension funds to sell liquidity assets in order to raise cash and cover margin calls. This led to an unprecedented sale of Asset-Backed Securities ("ABS"), particularly Residential Mortgage-Backed Securities ("RMBS") and Collateralised Loan Obligations ("CLOs"), which incurred the lowest market value losses given they are floating rate products.[22]

A recalibration of the Solvency II capital charges on assets to levels that are proportionate to the commensurate risks is also urgently needed for the return of insurers as investors in the securitisation market. While the capital calibrations for senior STS tranches have been set to levels which are more appropriate, the calibrations of non-senior investment grade STS and non STS tranches, which naturally fit European insurer investment mandates, remain disproportionately high and non-risk sensitive.[23]

Of course, the prudential framework is not the sole factor hindering the growth of the securitisation market. While the Commission decided against reopening the Level 1 text in the 2019-2024 mandate,[24] a future review of the SECR with a focus on the due diligence requirements imposed on institutional investors under Article 5, is fundamental for the growth of the investor base.

The lack of clarity surrounding investor due-diligence requirements, the administrative burden of demonstrating compliance with Article 5 and the limited flexibility that the SECR allows in the investment process are only some of the challenges that existing and new investors face.[25] With regards to third country transactions, the Commission's strict interpretation of Article 5(1)(e) in the SECR Report means that EU institutional investors are now required to obtain full Article 7 information from third country reporting entities.

While it is certainly positive that ESMA is currently reviewing the existing disclosure templates with a view to simplifying those for private transactions, third country sellers may be reluctant to make changes to their reporting systems given significant changes to the existing templates are expected to be brought in relatively shortly. As the Commission correctly acknowledges, this strict interpretation of Article 5(1)(e) "de facto excludes EU institutional investors from investing in certain third-country securitisations".[26] In fact, the effect of the Commission's comments in their SECR Report is to exclude EU institutional investors from investing in most third country securitisations, in many instances inhibiting EU lenders from extending their EU relationships to overseas subsidiaries and more generally reducing the ability for EU investors to diversify their risk through adoption of a global view of the product.

In the area of sustainable finance, market participants also welcomed the outcome of the political agreement reached on the European Green Bond Standard ("EuGBS") in February 2023, which included cash securitisation in its scope and followed the EBA's relevant recommendations.[27] In other words, the EuGBS requirements apply at the originator level rather than the issuer/securitisation special purpose entity ("SSPE") level, and the "use of proceeds" approach has been adopted, meaning that a securitisation not backed by a portfolio of green assets can still qualify for the "EuGB" label provided that the originator commits to using all the proceeds from the green bond to generate new green assets. As there is currently limited EU Taxonomy aligned green collateral to securitise, the "use of proceeds" approach, and securitisation itself by extension, can be an important enabler of the green transition.

However, synthetic securitisation, currently excluded from the framework, provides a much more cost effective way of securitising project finance and SME lending which cannot be easily securitised via cash securitisations. The importance of SME lending in the CMU project and the prolific use of project finance to fund renewable developments, such as photovoltaic and wind farms, highlight the relevance of synthetic securitisation to the purpose of the EuGBS which is to help finance sustainable investments. Consequently, its appropriate integration in the framework by legislators should be one of the future priorities. [28]

In summary, the next EU legislative cycle should focus on the following:

- Creating a better calibrated capital and liquidity treatment for securitisation under the CRR, LCR and Solvency II.
- Streamlining investor due diligence requirements by reviewing the Level 1 text.
- Supporting the nascent green securitisation market by incorporating synthetic securitisation in the scope of the EuGBS.

The revision of the ESMA disclosure templates is, of course, another top priority for the industry, but it is expected to conclude prior to the EU Parliament elections in June 2024.

The changing regulatory landscape in the UK

While the EU is slowly moving towards the end of the current political mandate, the UK, which exited the block in January 2020, has already introduced significant reforms to its financial services landscape. The recently introduced Financial Services and Markets Act ("FSMA" 2023)[29] repeals retained EU law, the SECR included, and establishes a new regulatory architecture whereby the UK's financial services will be regulated by the Financial Conduct Authority ("FCA"), the Prudential Regulation Authority ("PRA") and the Bank of England ("BoE").

The HM Treasury, which concluded its own review of the SECR in 2021 (the "Sec Reg Review"),[30] is prioritising reforms to securitisation which will be taken forward via the relevant statutory instrument.[31] While this remains in draft format at the time of writing, it seems that certain aspects of the previously retained EU law will be maintained, such as the STS regime and the regime for

Securitisation Repositories and Third-Party Verifiers. The FCA and the PRA, who will have rulemaking powers under the new regime, are expected to consider the relevant reform areas identified in the Sec Reg Review and set out their detailed approach to replacement rules in relevant consultations, such as the FCA consultation (CP 23/17)[31] and the PRA consultation (CP 15/23),[32] both of which were launched in the summer and will close on October 30, 2023. Separately, the PRA is also expected to examine the capital and liquidity treatment of certain securitisations.[32]

In the post-Brexit environment, the UK's ability to write its own rules will hopefully lead to a more flexible and adaptable set of regulations that is better able to meet the needs of a constantly evolving market. It will then be interesting to observe the impact of these rules on the UK securitisation market and identify any potential consequences resulting from the regulatory divergence between the EU and the UK.

Conclusion

Taking a step back, securitisation rightly constituted one of the key elements of the 2015 and 2020 CMU action plans. As a capital markets instrument, and due to its unique characteristics, securitisation can accelerate the realisation of the CMU and make considerable contributions to the real economy and green transition. However, despite the extensive reforms seen in the last four years, the European securitisation market (including the UK) has not scaled up significantly and is still lagging behind other jurisdictions. As Europe's financing needs are only expected to increase, a robust securitisation market in a well-designed and proportionate regulatory framework can only strengthen the European economy, reinforce its global competitiveness and make the financial system more resilient. For these reasons, securitisation regulation should remain a key area of focus within the UK and importantly within the next EU legislative cycle in order to unlock new reserves of capital much needed to finance structural change over the next decade.

Notes

1 Action plan on building a capital markets union, 30 September 2015 (https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0468).

2 Ibid (page 4).

3 Capital markets union 2020 action plan: A capital markets union for people and businesses (https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/capital-markets-union/capital-markets-union-2020-action-plan_en).

4 https://finance.ec.europa.eu/publications/coronavirus-response-how-capital-markets-union-can-support-europes-recovery_en#securitisation

5 Changes were also made to the Capital Requirements Regulation (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2021.116.01.0025.01.ENG&toc=OJ:L:2021:116:TOC).

6 The European Parliament elections are set to take place on 6-9 June 2024. The current Commission's mandate is set to end on 31 October 2024. In the meantime, the European Council is already preparing strategic orientations for the next Commission, namely a document that will be adopted by EU leaders after the European Parliament elections.

7 Eurostat data (https://ec.europa.eu/eurostat/web/products-eurostat-news/w/ddn-20230330-1#:~:text=According%20to%20the%20latest%20population,to%2027.3%20million%20fewer%20people.).

8 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the regions empty - Strategy for Financing the Transition to a Sustainable Economy, Strasbourg, 6.7.2021 (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021DC0390#footnote4).

9 High Level Forum Report on the Capital Markets Union (https://finance.ec.europa.eu/system/files/2020-06/200610-cmu-high-level-forum-final-report_en.pdf).

10 AFME, European Green Securitisation Regulatory State of Play (https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME_ESGSecuritisation_2022_07_final-2.pdf).

11 AFME Securitisation Data Snapshot Q2 2023 (https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Securitisation%20Data%20Snapshot%20Q2%202023.pdf).

12 As noted in this blog by the European Stability Mechanism ("ESM") (https://www.esm.europa.eu/blog/reviving-securitisation-europe-cmu).

13 All volumes are in EUR billion. AFME Securitisation Data Report Q4 2022 and 2022 Full Year. AFME, SIFMA, Bank of America, JP Morgan, NAB (National Australian Bank), Macquarie, S&P, World Bank. US and Australian volumes include ABS, RMBS, CMBS and CDO. US volumes exclude agency issuance. Australian volumes include ABS and RMBS. Charts show average annual securitisation issuance in 2011-2013 and 2020-2022 per jurisdiction. Exchange rate fixed as 2010-2022 average rate of EUR vs USD, JPY, AUD and CNY.

14 EBA report on developing a framework for sustainable securitisation (https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2022/1027593/EBA%20report%20on%20sustainable%20securitisation.pdf).

[15] European data includes the UK. US data includes agency issuance.

[16] Report from the Commission to the European Parliament and the Council on the functioning of the Securitisation Regulation (https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=COM:2022:517:FIN&from=EN).

[17] The Output Floor regime, as set out by the Basel Committee on Banking Supervision (BCBS (2017)), requires banks using IRBA to impose a floor on their calculations of Risk Weighted Assets ("RWAs"). This should equal a percentage of RWAs as calculated under Standardised Approaches ("SA"). Over time, the percentage will increase from an initial 50% to a level of 72.5%. Since bank equity analysts typically front-load their assessments, and because securitisation transaction are generally 5 years in maturity, in the short run, banks will face pressure to adjust their capital to be consistent with this ultimate percentage.

[18] RCL research report commissioned by AFME, "Impact of SA Output Floor on the European Securitisation Market" (https://www.afme.eu/Portals/0/DispatchFeaturedImages/Impact%20of%20the%20SA%20Floor%20on%20European%20Securitisation%2022-65a%20 14-6-22%20v68.pdf).

[19] https://www.eba.europa.eu/esas-publish-joint-advice-eu-commission-review-securitisation-prudential-framework

[20] RCL research report commissioned by AFME, "Comparing ABS and Covered Bond Liquidity" (https://www.afme.eu/Portals/0/DispatchFeaturedImages/Comparing%20ABS%20and%20Covered%20Bond%20Liquidity%2021-134a%2030-10-2021%20v22%20(003).pdf).

[21] The revision of the LCR in 2018 failed to promote STS senior tranches from Level 2B to Level 2A, and LCR eligibility was limited to "AAA" ratings only.

[22] https://www.twentyfouram.com/insights/abs-liquidity-is-there-when-you-need-it-most

[23] RCL research report commissioned by AFME, "ABS and Covered Bond Risk and Solvency II Capital Charges" (https://www.afme.eu/Portals/0/DispatchFeaturedImages/ABS%20and%20CB%20Risk%20and%20SII%20Capital%20Charges%2021-161a%2008-11-2021%20v25%20(003).pdf).

[24] Report from the Commission to the European Parliament and the Council on the functioning of the Securitisation Regulation (https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=COM:2022:517:FIN&from=EN).

[25] AFME paper, "Article 5 Issues Report: Due-diligence requirements for institutional investors under Article 5 SECR" (https://www.afme.eu/Portals/0/DispatchFeaturedImages/Article%205%20Issues%20Report%20-%20June%202023-1.pdf).

[26] Joint industry letter, "Request for guidance – Article 5(1)(e)" (https://www.afme.eu/Portals/0/globalassets/Securitisation%20Regulation%20-%20Request%20for%20guidance_Article%205%20(1)%20(e).pdf?ver=2022-12-15-100812-347&timestamp=1671098980586).

[27] EBA report, "Developing a framework for sustainable securitisation" (https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2022/1027593/EBA%20report%20on%20sustainable%20securitisation.pdf).

[28] AFME paper, "European Green Securitisation Regulatory State of Play: Obstacles to growth and opportunities for leadership" (https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME_ESGSecuritisation_2022_07_final-2.pdf)

[29] https://www.legislation.gov.uk/ukpga/2023/29/contents/enacted

[30] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1040038/Securitisation_Regulation_Review.pdf

[31] CP 23/17: https://www.fca.org.uk/publications/consultation-papers/cp23-17-rules-relating-securitisation

[32] CP 15/23: https://www.bankofengland.co.uk/prudential-regulation/publication/2023/july/securitisation

[33] Securitisation_Regulations_2023_-_Draft_SI.pdf (publishing.service.gov.uk) (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1168703/Securitisation_Regulations_2023_-_Draft_SI.pdf)

[34] Chapter 11 of HM Treasury's Review of the Securitisation Regulation.

Contact us:

AFME

London
Level 10, 20 Churchill Place, London, E14 5HJ,
United Kingdom
T: +44 (0)20 3828 2700

www.afme.eu

Brussels
Rue de la Loi 82, 1040 Brussels, Belgium
T: +32 (0)2 883 5540

Frankfurt
Neue Mainzer Straße 75, 60311 Frankfurt am Main,
Germany
T:+ 49 (0)69 710 456 660

Recent developments in the UK securitisation market

By Katie Grace and Sarah Caldwell, Reed Smith LLP.

The UK securitisation market is set to remain a key funding tool for many market participants, with residential mortgages continuing to be the most commonly securitised asset, despite recent interest rate volatility in the UK. The overlay of the new UK securitisation regulations on the horizon mean market participants will need to consider what effect the changes to the UK regime will have once implemented.

Emerging trends such as securitisations on the blockchain, together with further developments and investor interest in ESG securitisations, show continued market developments and innovation outside of the traditional securitisation technology.

More niche asset classes, such as aviation ABS, give investors the opportunity to diversify away from consumer-based ABS, with aviation ABS seeing interesting developments given the number of exogenous shocks over recent years affecting the aviation industry.

UK RMBS market

Within the UK, residential mortgage-backed securitisations (RMBS) remain the most established asset class, accounting for almost 60% of the securitisation market. The UK market has faced, and continues to adapt to, an unprecedented and volatile political and economic environment. Currently the UK is witnessing a significant squeeze on mortgage affordability driven largely by increasing inflation. This is resulting in a decrease in origination levels, particularly within the first-time buyer market, which is a key asset stream for the RMBS market.

The UK Government is looking to mitigate the impact of affordability on the secondary mortgage market, and recently announced that it has agreed a Mortgage Charter of support measures for borrowers with the Financial Conduct Authority and the UK's primary mortgage lenders. The Mortgage Charter allows borrowers to, amongst other

Sarah Caldwell   Katie Grace

Sarah Caldwell
Structured Finance Partner London
+44 (0)20 3116 2839
slcaldwell@reedsmith.com

Katie Grace
Structured Finance Partner London
+44 (0)20 3116 3736
kgrace@reedsmith.com

things, switch a mortgage to interest only for a period of time and extend their mortgage term to reduce their monthly payments. Whilst these measures will go some way to alleviating defaults, parties to RMBS transactions will now need to re-examine previously diligenced risk profiles within their deals.

These relief measures have the potential to significantly impact RMBS transactions by affecting mortgage pool eligibility criteria and breach thresholds. This will impact legacy RMBS deals arranged by a mortgage lender now applying the Mortgage Charter, and new RMBS deal setting criteria and thresholds at the outset. Going forward any specific waivers and risk factors relating to concentration limits and eligibility thresholds will need to be appropriately built into documentation to ensure compatibility of operation with the Mortgage Charter and the changing landscape of the mortgage market, throughout the transaction's lifecycle.

The UK RMBS market is resilient, and we are seeing encouraging signs of increasing numbers of non-bank and speciality lenders entering this market place. These new entrants have a desire to innovate and originate mortgage loans more efficiently in order to maintain a strong RMBS asset pool pipeline in the UK. These developments, together with the increasing prevalence of generative AI as a tool to better manage, analyse and report on RMBS deals, demonstrate strong signs of adaptation within the UK market to mitigate the challenging market conditions and safeguard RMBS transactions as a valuable source of liquidity going forward.

UK securitisation regulation

One key impact on the UK securitisation market is the Government's proposals for the UK's new securitisation regime (Draft Rules). The Draft Rules include a number of key changes to the existing regulations, however they are largely in line with the EU regime. This should be good news for market participants involved in UK and EU transactions, who should not encounter significant difficulties in complying with the different regimes.

The key changes include:

- Implementing a more principles-based approach to due diligence requirements applying to UK investors investing in non-UK securitisations by allowing sellers to provide information to investors without it being in the prescribed template (as required for UK sell-side parties).
- Welcome clarification on the timeframes within which certain transaction documentation must be disclosed to investors, before pricing and after closing.
- The FCA's intention to expand the definition of "public securitisation", imposing additional disclosure requirements on primary admissions to trading on UK MTF and similar non-UK venue admissions where there is at least one UK manufacturer.
- Allowing (i) for securitisations of non-performing exposures, the discounted (rather than the nominal) purchase value to be used to calculate the 5% risk retention, and (ii) for a transfer of retained risk if the retainer becomes insolvent, or where the risk is retained on a consolidated basis by the parent entity within a consolidation group and the risk retainer falls outside the scope of consolidated supervision (in each case to align the UK and the EU rules).
- The "sole purpose" test, which determines whether an entity can hold the risk retention as an originator, differs between the UK and EU regimes, with the UK regime being more flexible listing the matters which need to be 'taken into account', rather than such matters needing to be fully satisfied to pass the test, as per the EU regime.
- Unauthorised entities acting as an original lender, originator or SPV entity are now captured by the rules. The Draft Rules helpfully clarify that only UK established sell-side parties have to comply with the UK regime. On the buy-side, they limit the scope of due diligence requirements to only apply to UK-authorised alternative investment fund managers ('AIFMs') and small registered AIFMs.

The proposed regulatory consistency and clarity provided by the Draft Rules, which have been lacking over recent years, will be welcomed by those structuring the transactions as a vote of ongoing confidence in the wider regime, with the potential to generate more UK market activity.

Tokenisation and blockchain technology

Alongside traditional asset backed securitisations (ABS), a key evolution in the UK's securitisation market is the increasing demand for securitisations on the blockchain. Tokenisation transactions bring many benefits over traditionally papered ABS; with the utilisation of pre-programmable smart contracts allowing an additional level of security and execution certainty to be built into transactions.

Establishment on the blockchain also allows for a more streamlined process, with custody accounts, title deeds and ownership records all held on the blockchain, this in turn leads to reduced ongoing running costs and near-immediate settlement as compared to the customary T+2.

The UK Government has set out ambitious plans to regulate cryptoasset and blockchain activities, and intends to create a clearer regulatory regime for cryptocurrencies to better incorporate cryptoassets into the UK's financial services. Increased legal certainty should engender market confidence and pave the way for future growth of this new limb of the UK's securitisation offering.

A key hurdle for market participants to overcome in order to embed this market within the UK ABS economy is to address and de-risk the reputational concerns associated with products on the blockchain. Transactions involving digital assets on the blockchain represent a significant departure from traditional debt capital market deals, the anonymity of the blockchain and associated digital privacy will present anti-money laundering and due diligence considerations for parties who are customarily able to diligence bondholder identities.

This is an area where we see significant innovation within the UK securitisation market, with unique compliance tools being developed to offer participants opportunities to monitor, detect and respond to fraud, money laundering, sanctions evasion and other risks, including powerful blockchain analytic tools and services. Seasoned originators, arrangers, trustees and service provides will be well placed to exploit this evolving marketplace given their current access to sophisticated tools for risk management.

Going forward, the challenge for market participants will arise from the task of managing their role in a decentralised custody system on the blockchain, and ensuring secure access to this technology by combining the protection of property and privacy within this new technology.

ESG securitisation market developments

ESG labelled products are another area of the UK securitisation landscape with the potential for growth. ESG bonds can include green bonds, social bonds, sustainable bonds and transition bonds, whilst ESG loans can include green-linked loans and sustainable-linked loans. Whilst 2021 saw the greatest volume of ESG securitisations, 2023 is proving to be a year of increasing innovation within the sector, with RMBS deals originated covering social housing, improvement of home energy efficiency and access to mortgage finance.

Within the ESG space, a key class of RMBS gathering momentum is green securitisations comprised of eligible homes with an "A" or "B" Energy Performance Certificate (EPC) rating. Currently EPC properties awarded "A" or "B" EPC ratings are largely limited to new builds, it should be noted that this in turn limits the collateral pool within an RMBS and market participants should consider appropriate risk factors disclosing the diversity of the asset pool accordingly. However, this category is set for potential significant growth given its alignment with the UK Government's policy; under which all existing rented properties will need an EPC rating of "C" or above by the end of 2028, and new tenancies needing an EPC rating of "C" by the end of 2025. UK landlords are in the process of aligning their mortgaged rented properties, and in time this will allow a sufficiently large pool of assets to further support and accelerate this category of green securitisation.

A key pillar of the ESG market is the continued establishment of technical and proportionate disclosure standards. The market is developing rapidly and currently the prevailing disclosure templates do not have sufficient relevant categorisations for each set of ESG related data required for each type of ESG transaction. The UK Government is in the process of developing the UK Green Taxonomy, with the aim of defining which economic activities can be categorised as green together with providing recommendations to support the quality of standards, labels and disclosures to be applied within the green industry. This is an encouraging development for the green securitisation market and one which will support the industry through its focus on increased clarity and certainty of disclosure standards going forward.

Whilst the green securitisation market remains within the initial phases of development, increasing investor demand across the ESG bond and loan classes will drive issuances forward. This, coupled with the continued levels of investment in appropriate reporting frameworks will aid in removing barriers to entry and will pave the way for continued growth in this sector.

Aviation ABS – current snapshot

Aviation ABS issuances peaked in 2019 with a record 18 deals closing having a total value of almost US$10bn. Aircraft ABS remains an important component of the global commercial ABS space. Investors have been attracted by the ability to diversify away from consumer-based ABS which can offer benefits in an economic downturn, as well as by the sector's yield level relative to other similarly-rated products (with spreads typically outperforming subprime auto and the credit default swap index).

Aviation ABS deals include commercial aircraft, business jets, engines, and there is now an aircraft loan securitisation market. The aircraft leasing market is a global one, with active secondary trading of the metal and generally stable residual values (although unlike the used auto market, for example, there is no readily observable and reliable market price for aircraft values). Further, significant improvements have been made to international legal frameworks over the last decade, in particular with the widespread adoption of the Cape Town Convention, an international treaty which greatly facilitates uniform and predictable enforcement processes in respect of aircraft objects.

The COVID pandemic had a more sustained negative impact on aviation than on many other industries, cutting short the consistent growth enjoyed in aircraft ABS volumes between 2013 and 2019. As a consequence, there were just three aircraft securitisation issuances in 2022 in stark contrast to the 15 issuances in 2021. Now, with pandemic-era travel restrictions largely lifted, a sense of optimism is returning – but the ABS market remains essentially dormant. This is partly due to the unprecedented challenge in the form of Russia's invasion of Ukraine, which stranded more than 500 aircraft in Russia, a significant number of which were held in ABS structures, but at the heart of the problem, however, is cost.

In 2021, top-tier leasing companies were able to raise five-year senior unsecured debt at an all-in rate of around 2% to 2.5%; by 2023 this had increased to 6% or 7%. Although interest rate rises were expected, the real issue concerning investors has been the flat and inverted yield curve as well as the lagging lease rates, which are yet to keep pace with interest rates.

This is a market that continues to evolve and improve, but aviation debt is a niche asset requiring significant sectoral knowledge to access the markets and assess the financial viability, contractual features and collateral offerings. While aircraft demand has been increasing, the supply of new engines and aircraft remains constrained for a variety of reasons, including supply chain challenges, employment issues, regulatory scrutiny and manufacturing concerns, which have combined to result in far fewer aircraft deliveries over the last three years than the major manufacturers would have ordinarily envisaged. These delivery delays look set to continue. However for the ABS market, we view this as something of a positive given that the shortage of new aircraft and engines for purchase has increased the demand for leased aircraft – contributing towards the much needed higher lease rates.

***Contributing authors to 'Aviation ABS - current snapshot': Richard Hakes and Andrew Harper, Reed Smith LLP**

Conclusion

The securitisation industry remains a crucial tool in underpinning the UK's liquidity markets. Despite the current economic and political climate, there are encouraging signs of innovation within existing sectors such as RMBS and aviation ABS, together with growth into new and disruptive sectors, such as tokenisation. Furthermore, it is encouraging to see the increased regulatory attention afforded to this key market, with the UK Government currently prioritising legislative developments within the securitisation regulation space and the wider ESG securitisation industry. The UK securitisation market is therefore increasingly well equipped to capitalise on industry developments and to seize opportunities created by changing market conditions, to drive growth into 2024 and beyond.

Contact us:

Reed Smith LLP

20 Primrose Street,

London EC2A 2RS

UK

tel: +44 20 3116 3000

web: www.reedsmith.com

Sustainable securitisation – too complicated or worth the effort?

By Christian Fahrholz, True Sale International, Michael Osswald, STS Verification International and Matthias Schimka, Wolf Theiss

"IT'S NOT SIMPLE" HAS BEEN THE REACTION OF MANY SECURITISATION MARKET PARTICIPANTS WHEN THE SECURITISATION REGULATION INTRODUCED THE CONCEPT OF "SIMPLE, TRANSPARENT AND STANDARDISED" ("STS") SECURITISATIONS BACK IN EARLY 2019. WITH THE EMERGENCE OF SUSTAINABLE SECURITISATIONS, THINGS ARE AGAIN NOT QUITE AS STRAIGHTFORWARD AS ONE WOULD WISH.

During its young history, the regulatory environment for sustainable securitisations has already gone through several evolutions. But despite all the complications, this development holds opportunities for the much-needed growth of the European securitisation market and the financing of the sustainable transformation of the European economy, argue Michael Osswald (Managing Director, SVI) and Christian Fahrholz (Director, TSI).


Christian Fahrholz


Michael Osswald


Matthias Schimka

Christian Fahrholz, Director
True Sale International GmbH
Tel: +49 69 2992 1725
Email: Christian.fahrholz@tsi-gmbh.de

Michael Osswald, Managing Director
STS Verification International GmbH
Tel: +49 69 8740 34410
Email: michael.osswald@svi-gmbh.com

Matthias Schimka, Partner
Wolf Theiss
Tel: +43 1 51510 5395
Email: Matthias.schimka@wolftheiss.com

Regulatory evolution

Both securitisations and sustainable finance are at the heart of the European Commission's Action Plan on **Capital Markets Union**, even in its original version which dates back to 2015. Sustainable finance gained particular momentum in the aftermath of the launch of the **European Green Deal** by the European Commission in 2019. This is because one of the objectives of the European Green Deal is to mobilise at least €1 trillion in sustainable investments over the next decade and to channel private investment towards the transition to a climate-neutral economy.

It is therefore not surprising that sustainability considerations have already been embedded in the 2019 **initial Securitisation Regulation**[1], which introduced, as part of the newly established premium segment of "Simple, Transparent and Standardised" securitisations, a first set of requirements to disclose environmental information on the assets financed by certain types of STS securitisations. This was complemented, at the time of the implementation of the **amended Securitisation Regulation**[2] in Q2 2021, with the possibility for issuers to also publish the available information related to the principal adverse impacts of the assets financed by the underlying exposures on sustainability factors.

The most prominent proposal yet to appear relates to the **European Green Bonds Standard** which was published in draft form by the European Commission in July 2021, on which the European legislators have reached provisional agreement in February 2023 and which was approved by the European Parliament in early October 2023. This aims to establish criteria necessary for a bond to be designated "European Green Bond" across all types of unsecured and secured bonds including securitisations, and is intended to particularly support the European Commission's Action Plan on Financing Sustainable Growth formulated in 2018. As a consequence of all of these initiatives, the regulatory environment for sustainable securitisations[3] is currently characterised by the co-existence of various elements which, in the following, we will explore in more detail.

To start with, since the inception of the STS-segment under **the initial Securitisation Regulation**, the transparency criteria for non-ABCP securitisations have included the requirement for originators to publish environmental performance data of underlying exposures in the mainstream asset classes of residential mortgage loans and auto loans & leases, provided that such information is available to the originator and captured in its IT systems[4]. Looking at the history of the STS segment over the last few years, the above-mentioned provision has initially resulted in very few RMBS and Auto ABS transactions publishing such environmental performance data.

Originators including captive auto finance providers have cited in many cases a lack of availability of environmental performance data and uncertainty about their correctness as the main reasons for not publishing such information.

We note that over the last 12 months the number of STS transactions that report such environmental performance data is on the rise which can only be welcomed.

Looking beyond the environmental aspect, it could be argued that other STS criteria, including those in relation to simplicity and standardisation[5], already take account of sustainability ideas and objectives, in particular in relation to governance aspects – the final letter in ESG that often gets overlooked. Examples for this are the STS criteria that require a disclosure of the originator's underwriting standards, a minimum experience of the originator/servicer and the transaction documentation to clearly specify contractual obligations of the key transaction parties and other key structural features of the securitisation. Thus, a starting point was made in relation to sustainable securitisations.

On the flip side, however, the above-mentioned sustainability elements inherent in the initial Securitisation Regulation were not really compatible with the Sustainable Finance Disclosure Regulation (**"SFDR"**[6]) which came into force in March 2021 given that securitisations are not investment products in the sense of the SFDR. At the same time, the SFDR imposes mandatory ESG disclosure requirements on asset managers and other financial market participants at the "entity level".

Hence, this shortcoming was addressed in the **amended Securitisation Regulation**, which became effective in April 2021. This legislation was further detailed by the European Supervisory Authorities (EBA, ESMA and EIOPA[7]) in their draft Regulatory Technical Standards on sustainability disclosures for STS securitisations[8] in May 2022 for which a final draft was published in May 2023. This voluntary standard for selected asset classes, in particular residential mortgage loans and auto loans & leases (with other asset classes potentially to follow), is expected to help investors to comply with their disclosure obligations required by the SFDR from 2024 onwards. The upcoming standard will comprise information related to "the principal adverse impacts of the assets financed by the underlying exposures on sustainability factors", which is clearly more comprehensive compared to the environmental performance data required to be provided for STS securitisations under the initial Securitisation Regulation. The Regulatory Technical Standards, once effective, provide an option for originators to choose between these two regimes, whereby only securitisations in line with the draft Regulatory Technical Standard would presumably be at least partially eligible for the SFDR requirements. The importance of this should not be underestimated given that asset managers and bank treasuries represent the backbone of any investor base of a publicly placed securitisation transaction.

Lastly, the **European Green Bond Standard** represents, as adopted by the European Parliament in early October 2023, a voluntary standard to be used on a uniform basis across the EU for capital markets instruments that explicitly includes securitisations. Published as a draft in July 2021 by the European Commission and based on the recommendations of the Technical Expert Group on Sustainable Finance, the European Green Bond Standard aims to provide standardisation, transparency and supervision of external reviewers, thereby granting assurance to both issuers and investors on the level of sustainability of their investments and reducing the risk of greenwashing.

The importance of the European Green Bond Standard for securitisations is further heightened by the recommendations spelled out by EBA in its ground-breaking March 2022 report on “Developing a Framework for Sustainable Securitisation”. The EBA concludes, among other findings, that a dedicated framework for sustainable securitisation is premature for the time being, mainly due to the current limited availability of suitable green assets to securitise. By the same token, the EBA recommends for securitisation to go the route of the European Green Bond Standard, thereby creating a single standard for all fixed income products.

What can certainly be seen as good news for the securitisation market, the political stakeholders in Brussels have followed, to a large extent, the strong recommendations expressed by EBA and the vast majority of market participants to capture the specifics of securitisations. These include in particular the need to apply the use of proceeds approach at the level of the originator rather than the special purpose vehicle (i.e. the formal issuer) to avoid that the securitised underlying exposure needs to be already 100% sustainable and to enable the originator to use the proceeds of issued notes for the financing of sustainable investments in line with the definitions of the EU Taxonomy. At the same time, securitisations will need to disclose, in respect of the underlying securitised assets that form part of a securitisation and on a best efforts basis, the share of securitised exposures that finance activities that are taxonomy eligible or taxonomy aligned activities and the share of securitised exposures that fail to meet the Do No Significant Harm Principle.

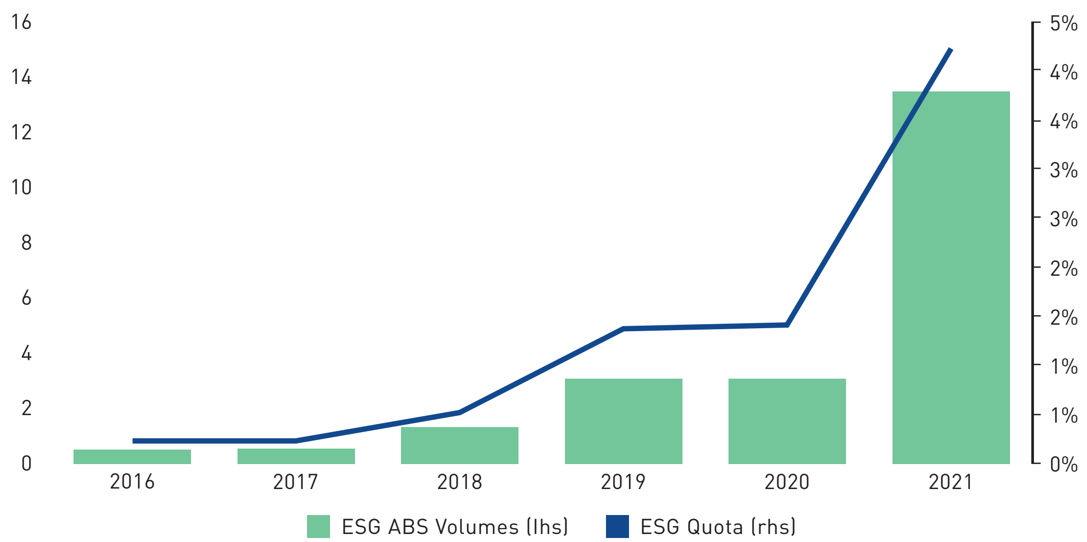
Unfortunately, the present draft European Green Bond Standard would allow only for true sale, non-ABCP securitisations to be eligible as European green bonds while synthetic on-balance sheet securitisations and ABCP securitisations, all of which are common and frequently used securitisation structures and each represent more than EUR 100 billion of issuance amount, are not enclosed in the current legislative process for the European Green Bond Standard.

As can be seen from the above, the regulatory environment for sustainable securitisation within the EU is currently very much in a state of flux. Against this background, an overview of the current market for sustainable securitisation may sharpen the understanding of how this market segment could evolve in the future.

Market overview

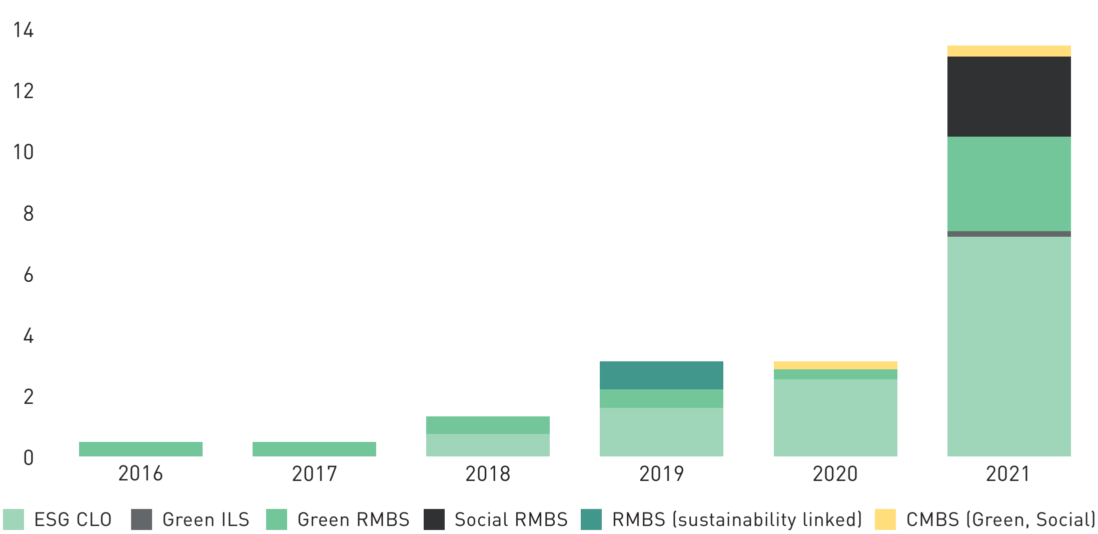
Despite the important future role they could possibly play in the financing of the transition to a (more) sustainable economy across Europe, the issuance amounts of sustainable securitisations in Europe are currently, despite strong recent growth, still at a very low absolute level and represent less than 5% of the total European securitisation issuance amount (**see Chart 1**).

European ESG securitisation volumes **Chart 1**



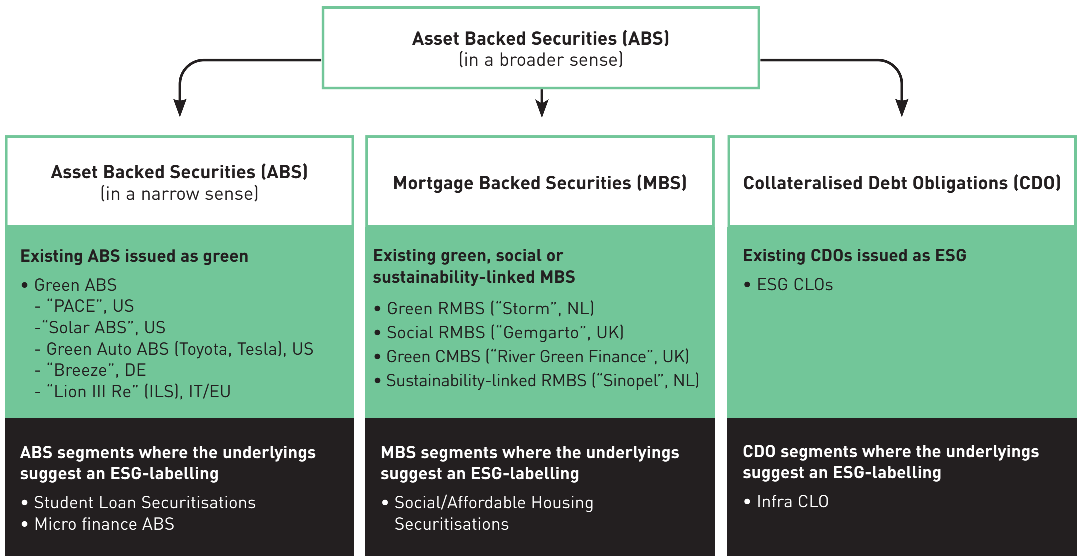
Source: DZ Bank Research

European securitisation classes **Chart 2**



Source: DZ Bank Research

Securitisation asset classes **Chart 3**



Source: DZ Bank Research

As can be seen from **Chart 2**, the European market for sustainable securitisations is dominated by Collateralised Loan Obligations ("CLOs") and RMBS transactions. In terms of the number of transactions, less than 20 sustainable securitisations have been observed over the last five years which have included the asset classes and transaction types summarised in **Chart 3**.

Recent examples of sustainable securitisations in the European market (not mentioned in Chart 3 above) include a series of consumer ABS issued by Auxmoney as Social Bonds, various Dutch, Spanish and Portuguese RMBS issued by originators such as ING, Obvion and UCI and the Green ABCPs issued by LBBW and Crédit Agricole CIB through their respective ABCP programmes that refinance small ticket E-bike lease contracts and auto lease contracts for battery electric vehicles, respectively. Virtually all of them have used the "Green Bond Principles" and the "Social Bond Principles" published by ICMA[9], which represents a concise and very workable set of voluntary frameworks issued by a private-sector association.

Outlook

One of the key features of securitisation – a financing instrument that forms part of the family of asset-based financings and similar to other types of asset-based financings such as asset-based lending for aircraft and ships and project & infrastructure financings – is that the cashflows that are used as the source of the debt service for the issued ABS notes derive directly from a well-defined portfolio of securitised loans or other underlying exposures. Due to the lack of securitisable assets, such as financings for electrical and/or hybrid vehicles or loans to finance energy-efficient properties in general or to upgrade existing properties to a higher energy efficiency level, this feature has so far not been able to be used for its own benefit in current sustainable securitisations. Instead, the focus is – rightly so in the view of the authors – very much on the use of proceeds approach in order to support the financing of the transition phase until such assets are more widely available.

Despite its rather accidental development, the establishment of a regulatory framework is crucial for the further development of the market for sustainable securitisations as the introduction of a reliable set of standards would greatly foster transparency and credibility of sustainable securitisations in the eyes of investors, regulators, politicians and other stakeholders, thereby avoiding any greenwashing issues. It appears that the European Green Bond Standard is, in the short term, set to be the available regulatory platform for the issuance of sustainable securitisations.

Interestingly, and similar to the STS regime, this standard involves the concept of a (mandatory) external reviewer as a crucial element in order to verify, on a pre- and post-issuance basis, the compliance of EU green bonds and their issuers with the taxonomy-compliant use of proceeds, the environmental strategy of the issuer and other aspects of the bond issuance required under the European Green Bond Standard. Given the widespread acceptance of the STS label over the last five years, it can only be hoped that the new segment of sustainable securitisation will be met with similar success. In this case, the extra effort required from issuers and investors will be surely worth the effort.

In any case it would be highly desirable to witness a level playing field between securitisation and other comparable fixed income instruments regarding the applicable sustainability requirements so that securitisations can play an active role within the overall market for Green Bonds.

This article is part of a series created by Wolf Theiss in cooperation with SVI and its parent company TSI. It is reproduced here with their kind permission. For the full series, visit true-sale-international.com and wolftheiss.com.

Notes:

[1] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation.

[2] Regulation (EU) 2021/557 of the European Parliament und of the Council of 31 March 2021, amending Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation to help the recovery from the COVID-19 crisis.

[3] In the following, the designations “sustainable securitisations”, “green securitisations” and “ESG-compliant securitisations” are used on a fully interchangable basis, with the common denominator being that they represent securitisation transactions that comply with one or more of the environmental, social, and governance (“ESG”) criteria.

[4] See Point 84 of the EBA Guidelines on the STS criteria for non-ABCP securitisation.

[5] See Articles 20 and 21 of the Securitisation Regulation.

[6] See Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability- related disclosures in the financial services sector.

[7] European Banking Authority, European Securities and Markets Authority and European Insurance and Occupational Pensions Authority

[8] See Joint Consultation Paper: STS securitisations-related sustainability disclosures, published by the Joint Committee of the ESAs dated 2 May 2022.

[9] See “Green Bond Principles” (June 2021) and “Social Bond Principles” (2021) published by the International Capital Market Association (“ICMA”) which have been complemented by updated guidelines such as “Sustainable Securitisation – Related Questions” (June 2022)

Contact us:

STS Verification International GmbH

Mainzer Landstr 61 ·

60329 Frankfurt

Germany

Tel: +49 69 8740 3440

Web: www.sts-verification.international.com

True Sale International GmbH

Mainzer Landstraße 61

60329 Frankfurt

Germany

Tel: +49 69 2992 1710

Web: www.true-sale-international.com

Wolf Theiss Rechtsanwälte GmbH & Co KG

Schubertring 6

1010 Vienna

Austria

Tel: + 43 1 515 10

Web: wien@wolftheiss.com

An overview of recent regulatory developments for EU securitisation

By Presiyan Petkov, Laura Izquierdo Rios, and Jana Sauka, European Commission

Securitisation allows credit institutions to transfer credit risk to investors while freeing up their balance sheet to provide more lending to the real economy. Needless to say, the benefits only outweigh the costs if securitisation structures are sound and market practices are safe. In the EU, securitisation is an integral building block of the Capital Markets Union. A revised securitisation framework became applicable in the EU in 2019 with the ultimate aim of establishing an EU securitisation market that helps finance the economy and the green transition, without creating risks to financial stability.

Introduction

While the framework has resulted in sound securitisation structures and safe market practices, industry participants point out that it has not improved access to credit and that the issuer base remains limited. Based on available data, overall issuance in the EU appears to be muted[1]. At this stage, it is unclear whether securitisation market developments are primarily driven by the regulatory regime or by other factors (e.g., impact of monetary policy, supervisory infrastructure, lasting 'stigma' from the Global Financial Crisis, etc.). The shift from low to rapidly increasing interest rates could change securitisation market dynamics going forward and increase the attractiveness of securitisations compared to other financial instruments.

This article will focus on the leading regulatory developments in the area of securitisation in the EU since the adoption of the Capital Markets Recovery Package in 2021. In particular, it will focus on the main messages from the first official review of the functioning of the Securitisation Regulation published in October 2022, a framework for green securitisation, and the prudential changes for securitisations included in the Banking Package.

Main messages from the 2022 review report

The 2022 Commission Report on the functioning of the Securitisation Regulation concluded that the Securitisation Regulation has been successful in achieving its main objective of developing a high-quality securitisation market that does not suffer from the same deficiencies identified during the global financial crisis. The new legal framework has provided a high level of investor protection through risk retention and information availability, facilitated risk monitoring, and further integrated the market. Since the publication of the 2022 report, the Commission has also adopted the regulatory technical standards that set out the specifics of the risk retention procedures, giving greater legal certainty to market participants.

Nevertheless, the Commission observed that the time since the new legal regime for securitisation entered into application had been relatively short and market participants and supervisors were still in the process of translating the legal provisions into practice. Moreover, some important elements had been added only recently. Therefore, the Report concluded that more time was needed to get a comprehensive picture of the full impact of the new framework.

An important point that stakeholders highlighted in their feedback was the lack of proportionality in due diligence and transparency requirements, resulting in high compliance costs and possibly constituting a barrier to the entry of new players in the market. Stakeholders stressed the need for simplification while protecting investors and facilitating supervision.

Stakeholders also had questions about the jurisdictional scope of the Securitisation Regulation, specifically on the interpretation of Article 5(1)(e) regarding transparency requirements for third-country securitisations, as well as the buy-side obligations of third country Alternative Investment Fund Managers (AIFM) as investors. On third-country securitisations, the Commission clarified that differentiating the scope of information provided for third-country securitisations is not in line with the intention of EU legislators. From an investor protection and financial stability perspective, both EU and third-country securitisations should be subject to the same level of transparency. Lowering transparency requirements for third-country securitisations alone could result in a competitive disadvantage to EU entities and create an unlevel playing field. Therefore, concerns regarding transparency requirements for third-country securitisations should not be seen in isolation, but incorporated in ESMA's on-going review of the disclosure templates.

On the buy-side obligations for third country AIFM investors, the Commission clarified that third-country AIFMs that market and manage funds in the EU are also required to comply with the due diligence requirements of the Securitisation Regulation for all their securitisation investments, since exempting third-country entities from these rules could undermine the comprehensive protection coverage afforded to investors. This rule is not extraterritorial since the activity that is being regulated takes place within the EU. The Commission also clarified that sub-threshold AIFMs[2] should also be considered institutional investors within the meaning of the Securitisation Regulation.

As part of the review, the Commission also reflected on the supervisory framework that spans over the securitisation market. No major shortcomings in supervision have been identified in the reporting period and currently there does not seem to be a case for changing the legislative framing of supervisors' activity. At the same time, the Commission concluded that greater convergence and coordination between competent authorities would be beneficial to legal


Presiyan Petkov


Laura Izquierdo


Jana Sauka

Presiyan Petkov
Email: Presiyan.PETKOV@ec.europa.eu
Policy Definition and Coordination Unit

Laura Izquierdo
Email: Laura.IZQUIERDO-RIOS@ec.europa.eu
Policy Definition and Coordination Unit

Jana Sauka
Email: Jana.SAUKA@ec.europa.eu
Banking regulation and Supervision Unit
DG FISMA, European Commission

certainty and the level playing field and it would support growth in the securitisation market.

In addition to the clarifications and assessments provided above, the Commission acted upon a number of concerns raised by stakeholders that can be addressed within the current regulatory framework. First, the Commission invited ESMA to review the disclosure templates for underlying exposures in securitisation, including the use of loan-level data, and to create a dedicated template for private securitisations. The goal here is to help supervisors gain a better overview of the market and its main features, while simplifying transparency requirements for issuers. Second, the Commission asked the Joint Committee of the ESAs to continue monitoring developments in the volumes of private and public transactions to get a better overview of the market and its risks. Third, the Commission recommended to the Joint Committee of the European Supervisory Agencies to explore the feasibility of having a lead supervisory authority to mitigate the current fragmentation of supervisory responsibility. Last but not least, the Commission asked the Joint Committee to develop guidelines on a common supervisory approach at EU level to monitor compliance with the requirements for simple, transparent, and standardised (STS) securitisations.

Green securitisation framework

The Securitisation Regulation stops short of providing a dedicated regime for green securitisation, leaving it to the market to develop common practices for structuring and transparency. The Regulation includes only a limited disclosure obligation to make sustainability disclosures for STS securitisations, concerning the available information on the environmental performance of underlying assets that are residential loans, auto loans or leases.

While the market for 'sustainable' bonds started to grow in the EU, the securitisation segment remained underdeveloped[3] in comparison, partly reflecting the small volume of 'sustainable' or 'green' assets to securitise. In addition, securitisation was not considered a financial product under the Sustainable Finance Disclosure Regulation which might have further curbed investor appetite.

The new European Green Bond Standard (EuGBS) will help address these issues and provide an impetus for a green securitisation market to develop. With this Regulation, which is about to become law, the EU aims to create a gold standard for green bonds. Only securitisations where the originator uses all the proceeds from the issuance for financing taxonomy-aligned activities will be eligible. In line with the recommendation of the European Banking Authority[4], in view of the scarcity of taxonomy-aligned assets, the Regulation will apply the use-of-proceeds requirement to the securitisation originator, rather than to the special purpose entity issuing the securitisation bond. This is an efficient and pragmatic approach in the current market environment until an adequate volume of eligible assets is generated in the Union, enabling securitisation to play a more meaningful role in the green transition.

A green securitisation standard where the underlying assets are not 'green' might appear counterintuitive for investors. Therefore, specific disclosures will apply to EuGBS securitisation bonds in addition to those applicable to non-securitisation EuGBS bonds. Namely, the originator should, on a best effort basis and to the best of their ability, disclose information about taxonomy eligibility, taxonomy alignment and compliance with the principle of 'do no significant harm' in respect of the activities financed by the securitised exposures. Together with the due diligence requirements applicable to all EU institutional investors in the securitisation market, which require that the investors base their investment decision on a well-informed analysis of the underlying pool of assets and the characteristics of the securitisation, this additional disclosure aims to ensure that investors are well informed about the green characteristics of the underlying pool thereby avoiding potential greenwashing concerns.

In addition, safeguards will be put in place to avoid the inclusion of exposures financing fossil fuels activities in the underlying pool. In this respect, the predominant purpose of the securitised exposures will be considered, and the mere use of fossil fuels would not be a disqualifying factor for specific securitised exposures.

The political agreement reached in spring 2023 is expected to be formally ratified by the Council and Parliament (in Q4 2023) and the EuGBS will be available for use one year after its entry into force.

Another important development in the area of green securitisations is the upcoming regulatory technical standard specifying the content and format for disclosure of available information related to the principal adverse impacts on sustainability factors of certain types of assets, which is still pending adoption by the Commission. This voluntary disclosure obligation, building on the Sustainable Finance Disclosure Regulation, will enable originators of STS securitisations that wish to report information on principle adverse impacts to their investors to do so via a standardised template. In addition to further enhancing the transparency of the STS securitisation market and aligning it with the latest climate disclosure standards, this measure will also facilitate the due diligence of institutional investors that are required to disclose the sustainability characteristics of their investments.

Targeted amendments to the prudential framework

The main development in the area of the prudential treatment of securitisation in the EU since 2021 has been an expected introduction of a targeted amendment as part of the Banking Package negotiations on wider revisions of the CRR, in the context of implementation of the Basel III rules in the EU. The expected amendment aims to foster the EU securitisation market and mitigate the unintended consequences of the introduction of the Standardised Approach output floor on securitisation transactions, as it should introduce a targeted relief for banks using internal models for calculation of capital requirements for their securitisation positions. The relief should be implemented via halving the 'p-factor', the main parameter ensuring the non-neutrality of the capital requirements for the securitisation. The p-factor is now halved to 0.25 for the STS securitisations eligible for the preferential capital treatment, and to 0.5 for all other securitisations. The change should be in force from 2025.

The above-mentioned transitional provision in the context of the Banking Package was preceded by a publication of the report by the three ESAs on the prudential review of the securitisation framework, in December 2022. While concluding that the prudential framework does not constitute a key obstacle to a revival of the EU securitisation market, the ESAs have proposed some technical adjustments to bring more consistency, clarity, and risk sensitiveness to the banks' capital framework. This has included a recommendation to reduce the risk weight floor for senior tranches retained by originators, to reflect reduced agency and model risks. On the other hand, the ESAs did not propose a reduction of the capital requirements by reducing the p-factor, a proposal strongly favoured by market participants.

Going forward, two other pieces of regulation are expected to be endorsed by the Commission in due course, that should contribute to a more risk-sensitive prudential framework for securitisation: first, technical standards that will determine the exposure value of synthetic excess spread in synthetic securitisation transactions, and second, technical standards on the calculation of the capital requirement on the securitised exposures for banks using the internal ratings based approach (SEC-IRBA) in accordance with the purchased-receivables approach that should enhance the use of SEC-IRBA by the investors.

Next steps

Even though the Commission report did not identify the need for changes to the Regulation at the time of its publication, the work on assessing the effectiveness of the framework and identifying ways to improve it, where necessary, continues.

The Joint Committee of the ESAs is expected to produce their second review report under Article 44 of the Securitisation Regulation in the second half of 2024. The Commission will use this Report as important input, when assessing the need for adjustments to the legal text. Other inputs that will contribute to that assessment will be the ESRB's second report on the financial stability implications of the securitisation market in the EU, ESMA's peer review of the STS framework and ESMA's ongoing review of the disclosure framework.

With regard to the prudential regulation, in terms of medium-term steps, the amended CRR should include a new mandate for the EBA to submit a report on the prudential treatment of securitisation, by December 2026. Following that, the Commission should be empowered to take a legislation action if considered appropriate. The review would be an opportunity to take stock of the market and regulatory developments including at Basel level, as well as to assess appropriateness of specific prudential issues such as, for example, the non-neutrality factors or the significant risk framework.

The views expressed in this article are purely those of the writers and may not, in any circumstances, be interpreted as stating an official position of the European Commission.

Contact us:

DG FISMA, European Commission

Rue de Spa 2, 1000 Brussels

Belgium

email: FISMA-A1@ec.europa.eu

web: https://ec.europa.eu/info/departments/financial-stability-financial-services-and-capitalmarkets-union_en

Notes

1. Aggregate data on the entire market (public and private) is not available and therefore no definitive conclusion can be taken.
2. Sub-threshold AIFM means a small AIFM benefitting from a de minimis exemption and which is therefore only required to comply with the AIFM directive (and its specific Member State's implementing law) in respect of the registration and reporting obligations, but does not benefit from the marketing passport.
3. Potential of green securitisation could exceed €300 billion annually by 2030 | AFME [https://www.afme.eu/news/press-releases/details/potential-of-green-securitisation-could-exceed-300-billion-annually-by-2030]
4. EBA recommends adjustments to the proposed EU Green Bond Standard as regards securitisation transactions | European Banking Authority (europa.eu) [https://www.eba.europa.eu/eba-recommends-adjustments-proposed-eu-green-bond-standard-regards-securitisation-transactions]

Securitisation in Luxembourg – an established market in Europe looking towards further flexibility

by Andreas Heinzmann, LL.M., GSK Stockmann

TWO PRINCIPAL REGULATIONS APPLY TO SECURITISATION TRANSACTIONS CARRIED OUT IN LUXEMBOURG: THE LUXEMBOURG LAW OF MARCH 22, 2004 ON SECURITISATION UNDERTAKINGS (THE SECURITISATION LAW) AND EU REGULATION 2017/2402 OF THE EUROPEAN PARLIAMENT AND COUNCIL OF DECEMBER 12, 2017 THAT LAYS DOWN A GENERAL FRAMEWORK FOR SECURITISATION AND CREATES A SPECIFIC FRAMEWORK FOR SIMPLE, TRANSPARENT AND STANDARDISED SECURITISATION (THE EU SECURITISATION REGULATION).

Applicable legal framework

The Securitisation Law, especially after its last amendment of February 25, 2022 is very flexible and allows any type of securitisation transaction.

This law defines securitisation as a transaction by which a securitisation undertaking acquires or assumes, directly or through another undertaking, risks relating to claims, other assets, or obligations assumed by third parties or inherent to all or part of the activities of third parties and issues financial instruments or enters into any form of borrowing, whose value or yield depends on such risks.

The novel feasibility of securitisation vehicles to be financed via loans or financial instruments that don't necessarily qualify as securities will further foster the competitiveness and attractiveness of the Luxembourg securitisation market.

Securitisation undertakings are in principle not subject to supervision by the CSSF (*Commission de Surveillance du Secteur Financier*) unless they intend to issue securities to the public on a continuous basis. The Securitisation Law now clarifies that 'on a continuous basis' means more than three issues of financial instruments to the public per year, whereby there is a public offering when financial instruments are not exclusively addressed to professional investors or have a minimum subscription amount of below €100,000.

Andreas Heinzmann, LL.M., Partner
GSK Stockmann
tel: +352 271802 30
email: andreas.heinzmann@gsk-lux.com

The provisions of the EU Securitisation Regulation, and most importantly, its scope of applicability should also be considered when the issuance of tranched securities is contemplated. The applicability of the EU Securitisation Regulation triggers, *inter alia*, risk retention requirements, due-diligence obligations and specific reporting obligations towards the CSSF.

With respect to the placement of securities to investors, the framework set out by Directive 2014/65/EU of the European Parliament and of the Council of May 15, 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast) (MiFID II), by Regulation (EU) 2017/1129 of the European Parliament and of the Council of June 14, 2017 on the prospectus to be published when securities are offered to the public (the Prospectus Regulation), and Regulation (EU) No. 1286/2014 on key information documents for packaged retail and insurance-based investment products (the PRIIPs Regulation) should be taken into account, in particular when the securitisation undertaking is offering securities to the public.

Overview of the Luxembourg securitisation market

Since the adoption of the Securitisation Law in 2004, Luxembourg has been a very active market for the set-up of multi-compartment securitisation undertakings and the structuring of securitisation transactions and has become one of the major hubs for securitisation transactions in Europe. The flexibility of the Law allows any type of securitisation transaction, be it a private placement or an offer of financial instruments to the public, true sale or synthetic, tranched or untranched.

Securitisation undertakings may be regulated or unregulated and can create compartments to ring fence the assets and liabilities of a securitisation transaction from those of other transactions of the same securitisation undertaking. There are currently ca. 1,500 securitisation undertakings (having more than 6,000 compartments) active in Luxembourg. Only a very small portion of them is regulated.

Eligible assets under the Securitisation Law

The Securitisation Law does not provide for any limitation with respect to the assets and risks that may be securitised. The Luxembourg Commission for the Supervision of the Financial Sector (the CSSF) issued a Frequently Asked Questions document on securitisation (the CSSF FAQ). This is generally used as guidance for both regulated and unregulated securitisations.

Securitisation vehicles in Luxembourg mainly invest in loans and debt securities. A significant proportion of them have exposures in equity instruments or fund units. Moreover, the Securitisation Law now explicitly allows the active management of securitised assets in certain types of transactions which are not financed by way of a public offering of financial instruments.

Hence, Luxembourg securitisation undertakings may now securitise a pool of risks consisting of debt securities, financial debt instruments or receivables that are actively managed, either by the undertaking itself, or, as is usually the case, by a third party. In practice, the new legal framework allows for the securitisation of actively managed Collateralised Debt Obligations (**"CDOs"**) and Collateralised Loan Obligations (**"CLOs"**) in private placements.

Available securitisation undertakings under the Securitisation Law

The Securitisation Law allows securitisation undertakings to be set up either in the form of a transparent fund or in the form of a company. For both types of securitisation vehicles, Luxembourg law offers a great deal of flexibility. Hence, there are no actual regulatory or practical restrictions on the nature of securitisation undertakings.

Following the implementation of the Anti-Tax Avoidance Directive (ATAD) framework the attractiveness of securitisation funds has increased due to their tax-transparent nature. They can be legally structured either as co-ownership(s) or as fiduciary estate(s), either option must be specified in their management regulations.

While securitisation funds structured as co-ownerships are also governed by the Luxembourg civil code, the very specific civil law rules pertaining to undivided co-ownerships (*indivision*) are expressly excluded by the Securitisation Law. The purpose of this exclusion is to avoid the unanimous decision-making rules applying to undivided co-ownerships as provided for in the civil code.

Securitisation funds organised as a fiduciary estate are also governed by the Luxembourg law dated July 27, 2003 on trust and fiduciary agreements, as amended.

Both types of securitisation funds are managed by a management company. The only practical restriction in this respect is that their structuring will need specific attention to avoid the risk of qualification as an alternative investment fund. While solutions exist to avoid such qualification, which mainly relate to the types of securities issued, the absence of a defined investment policy and the absence of active management, a tailored and cautious drafting of the management regulations of the securitisation fund is paramount.

Securitisation companies may be set up either as a public limited liability company (*société anonyme*); a corporate partnership limited by shares (*société en commandite par actions*); a private limited liability company (*société à responsabilité limitée*) and as a co-operative company organised as a public limited company (*société cooperative organisée comme une société anonyme*).

Following the recent amendments to the Securitisation Law, they may also now take the form of an unlimited company (*société en nom collectif*); a common limited partnership (*société en commandite simple*); a special limited partnership (*société en commandite spéciale*) and a simplified joint stock company (*société par actions simplifiée*). These entities are also governed by the provisions of the Luxembourg law of August 10, 1915 on commercial companies, as amended (the Companies Law).

Bankruptcy remoteness under the Securitisation Law

In accordance with the provisions of the Securitisation Law, bankruptcy remoteness in securitisation undertakings is achieved through the use of statutory or contractual limited recourse and non-petition clauses set out in the issuance and incorporation documentation of the securitisation undertaking.

Limited recourse clauses provide that the rights of investors and creditors of the securitisation undertaking or of its compartments are limited to the assets of such undertaking and its compartments. These clauses are associated with non-petition clauses, whereby the investors and creditors of the undertaking or its compartments commit not to start bankruptcy proceedings against the undertaking once the assets allocated to the vehicle or the relevant compartments have been realised despite a shortfall.

Subordination under the Securitisation Law

The Securitisation Law expressly acknowledges the validity of subordination clauses in the context of securitisation transactions even if the relevant agreements or terms and conditions of the securities are not governed by Luxembourg law. Therefore, subordination provisions will be upheld by Luxembourg courts.

True sale or synthetic securitisations under the Securitisation Law

A securitisation can be completed (i) on a true sale basis, whereby the securitisation undertaking acquires full legal title in relation to the underlying assets; or (ii) by the synthetic transfer of the risk pertaining to the underlying assets through the use of a derivative instrument or a guarantee.

With regard to the latter instrument, on July 10, 2020 the law on professional payment guarantees was passed (the Professional Guarantee Law). The Professional Guarantee Law will significantly strengthen the use of Luxembourg law governed guarantees in the context of synthetic securitisations and provide more legal certainty as regards the potential insurance-like character of such a risk transfer.

Effectiveness of the asset transfer in a true sale scenario under the Securitisation Law

In accordance with the provisions of the Securitisation Law, the assignment of an existing receivable to a securitisation undertaking becomes effective between the parties and against third parties from the moment the assignment is agreed on unless the contrary is provided for in such agreement.

The receivable assigned to a securitisation undertaking becomes part of its property as from the date on which the assignment becomes effective. There exists, under article 1690 of the Luxembourg civil code, a requirement to notify the obligor of the assignment. A failure to comply with this requirement does not make the assignment void, neither between the parties nor as against third parties, but the debtor of the assigned obligation is validly discharged from its obligations by paying to the assignor as long as the debtor has not gained knowledge of the assignment.

Further, the assignment of future claims to a securitisation undertaking is possible, provided that the future claim can be identified as being part of the assignment at the time it comes into existence.

Type of securities to be issued under the Securitisation Law

Prior to the amendments to the Securitisation Law securitisation undertakings were able to finance the acquisition or assumption of risks, only via the issuance of securities. The scope of the Securitisation Law has now been enlarged to encompass the feasibility of securitisation undertakings to be financed either via the issuance of financial instruments and/or via any type of borrowings.

This amendment enhances legal certainty and allows securitisation vehicles to be financed with securities and instruments that do not qualify as transferable securities under foreign law. It will also allow securitisation undertakings to be financed by all types of loans (i.e. any type of indebtedness under which a repayment is due and depends on the cash flows of an underlying).

The financial instruments or borrowings issued by a securitisation undertaking may be untranched, i.e. all noteholders'/creditors' claims will rank *pari passu*, or tranched providing for junior and senior noteholders/creditors. The Securitisation Law also provides for rules governing the legal ranking of different instruments issued by the securitisation undertaking (e.g. shares/fund units, beneficiary shares, notes etc.).

The new subordination rules are aligned with the general rules applicable to commercial companies and funds and incorporate the subordination principles in accordance with current market practice. However, parties can also derogate from these principles, as the securitisation vehicle's articles of incorporation, management regulations or the relevant issue documents may contain provisions providing for a different ranking of the claims.

In accordance with the provisions of the Companies Law the financial instruments issued by the securitisation undertaking can be issued in bearer, registered or dematerialised form. Further, in accordance with the law dated March 1, 2019, a securitisation undertaking may also issue security tokens, which can be held in the blockchain.

It should be noted that in the context of the issue of securities by a Luxembourg securitisation undertaking the articles 470-3 – 470-19 of the Companies Law applying to noteholder meetings can be contractually excluded and replaced by more flexible terms agreed between the parties.

As a matter of principle, a securitisation undertaking may also issue securities governed by a law other than Luxembourg law.

Due diligence requirements under the EU Securitisation Regulation

The Securitisation Law does not mandate a regulatory obligation for investors to conduct due diligence before investing in a securitisation position.

However, if a transaction qualifies as a securitisation under the EU Securitisation Regulation, institutional investors are required to perform the minimum due diligence involving various verifications.

Prior to holding the securitisation position, institutional investors must verify that the originator or original lender has established and actually applies "sound and well-defined criteria" in the granting of the credits, which constitute the underlying exposures, and that it is compliant with the risk retention and transparency requirements imposed by the EU Securitisation Regulation for all qualifying securitisations. The investors must also carry-out a due diligence assessment, which enables them to assess the risks involved with the securitisation.

Once they are holding the securitisation position, institutional investors are also bound by ongoing due diligence requirements:

(i) to establish appropriate written procedures that are proportionate to the risk profile of the securitisation position;

(ii) to perform stress tests on the cash flows, the collateral of the underlying and the liquidity of the sponsor, as the case may be;

(iii) to ensure internal management reporting; and

(iv) to be able to demonstrate to the CSSF upon request that they have a comprehensive and thorough understanding of the securitisation position and exposures and of the credit quality of the sponsor.

Further, some additional due diligence obligations may arise as a result of an investment strategy or specific guidelines agreed between the investor and its clients on behalf of whom the investment is made. They may also arise as a result of the regulatory status of the investor itself.

Risk retention under the EU Securitisation Regulation

There are no risk retention requirements under the Securitisation Law. However, provided a securitisation transaction falls within the scope of the EU Securitisation Regulation, the originator, sponsor or original lender of such a securitisation must retain, on an ongoing basis, a material net economic interest in the securitisation transaction of no less than 5%.

Data protection in the context of securitisation transactions

In Luxembourg there are no specific data protection principles applying to debtors in the context of a securitisation. However, as in other EU Member States, data protection is ensured by the direct application of Regulation (EU) 2016/679 of the European Parliament and of the Council of April 27, 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data (the GDPR).

In practice, where a securitisation implies a transfer of personal data to the securitisation entity, this issue is dealt with, on the one hand, by getting the consent of the data subject ab initio, when the receivable is created or, on the other hand, using a data trustee, where only information that is strictly necessary to the securitisation issuer is communicated to it, until a default occurs under the receivable. This type of mechanism is often used in cases of the securitisation of consumer receivables.

Contact us:

GSK Stockmann SA

44, Avenue John F. Kennedy

L-1855 Luxembourg

tel: +352 2718 02-00

email: luxembourg@gsk-lux.com

Website: www.gsk-lux.com

Green infrastructure securitisation development in Asia

By Dr Stan Ho Ho Ming, Asia Pacific Structured Finance Association (APSA)

There is a high urgency to mobilise private finance to decarbonise infrastructure globally, as energy, industry and buildings account for more than 70% of global greenhouse gases (GHGs); and public funding alone will not be enough to pay for the US$93.2 trillion transition at the scale and speed needed to meet the Paris Agreement goals limiting global warming to 1.5°C by 2030.

Introduction

It is not clear how private financiers, asset owners and policy-makers can work together to move from the current position, in which private capital principally flows to developed nations - largely into assets that are already generating predictable revenues - to a future position in which money also flows to what is often perceived as riskier and less stable opportunities in under-financed emerging and frontier markets.

There is a certain practicality at work. Environmental, social and governance (ESG) commitments adopted by lenders, investors and policy-makers in these economies are driving positive results, including advancing the search for low-carbon technologies and assets, such as carbon capture and storage, hydrogen use, and renewable energy projects. Besides, over the last decade, a record level of dry powder from infrastructure funds has been matched by a steadily increasing need for investment in new and retrofitted infrastructure.

However, a large majority of the infrastructure money has yet to be invested in new builds and technology, as investors in these funds tend to be savings institutions looking for lower-risk, lower-return exposure. According to the OECD, US$120 trillion of spare capital is held by private equity funds, banks and other private investors. At the same time, the United Nations estimates that 75% of the infrastructure needed by 2050 has yet to be built, the vast majority of which is in emerging markets.

Green infrastructure securitisation is expected to be one of the effective means of enlarging the investor base for the much-needed funding in Asia Pacific.

Green infrastructure securitisation

The generic infrastructure structure envisages the purchase of a pool of loan participations by a special purpose vehicle (SPV) financed by the issuance of tranches of rated securitised bonds and unrated “equity”. The securitisation tranches are rated by credit rating agencies according to their seniority within the capital structure with the senior most tranche considered the least risky and the equity being the riskiest tranche. A broad range of investor groups purchase the tranches based on their individual risk and return preferences and investment criteria. An asset manager typically manages the underlying pool of loans by constructing a portfolio and optimizing portfolio performance.

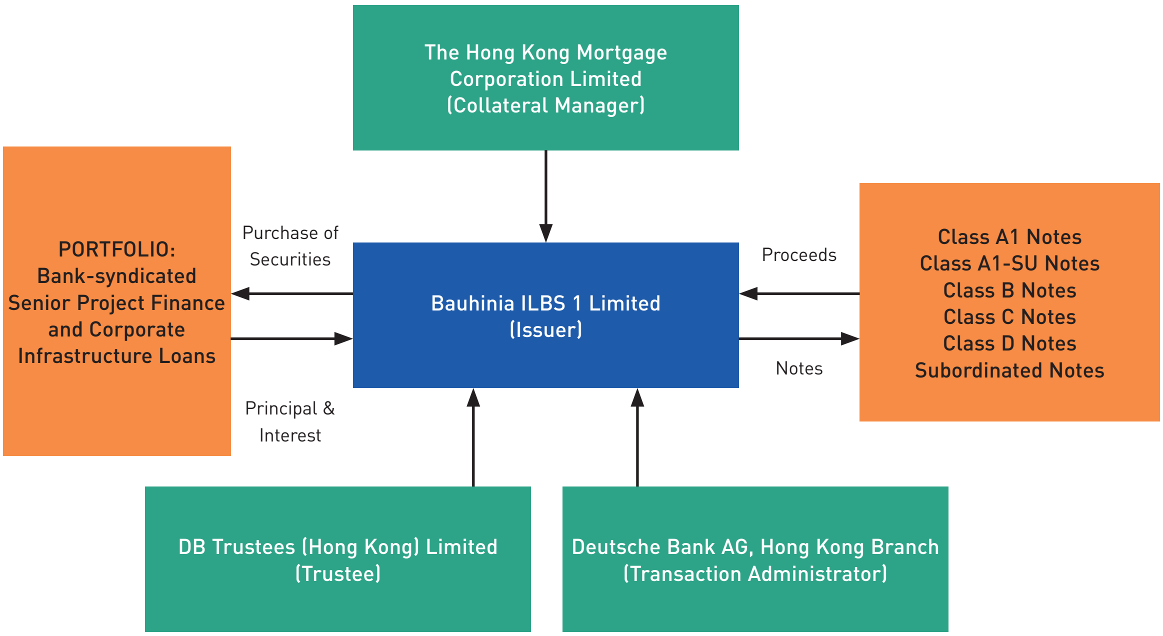
Green infrastructure loans are more complex and long dated that assets generally used to populate ABS such as leases, credit card receivables and mortgages. It is due to this complexity that requires monitoring and actions by a manager well aquatinted with the underlying assets, hence, why a securitisation issued by an asset manager is optimal to sustainable infrastructure. By transferring the credit risk of the underlying loan portfolio to bond investors via securitisation, securitisations have accelerated loan issuance, freed up bank lending capacity and thereby expanded overall credit formation. The same principles can be applied to the sustainable loan market to accelerate credit formation for other sustainable projects.

Green infrastructure securitisations are warming up to take their rightful place as a pillar of the sustainable securitisation revolution. The supply of assets for this product is plentiful and given the vast commitments by financial institutions to increase the quantity of green loans on their books, this trend looks set to continue. Sustainable borrowers are becoming increasingly diverse in terms of profile and use of sustainable use-allocated funds. For example, oil companies are increasingly investing in renewable projects and innovations such as electric aircraft are on the horizon.

Bauhinia ILBS 1 Limited

Bauhinia ILBS 1 Limited (the, issuer) is a pilot project finance and corporate infrastructure collateralised loan obligation (the CLO or the transaction) cash flow securitisation transaction, sponsored by The Hong Kong Mortgage Corporation Limited (HKMC, the collateral manager).

Bauhinia ILBS - Structure Diagram **Exhibit 1**



Source: Moodys

The notes issued by the issuer are backed by a US$404.78m portfolio of bank-syndicated project finance loans and corporate infrastructure loans predominantly in Asia-Pacific, the Middle East and South America at closing. All the loans were acquired directly from or by way of funded participation with HKMC or rated bank(s) around the closing date.

Of the US$404.78m portfolio, US$6.68m relates to undrawn commitments, which were deposited in the issuer's bank account at closing, pending to be drawn by the borrowers.

HKMC was established in Hong Kong in 1997 and is wholly owned by the Hong Kong Government through the Exchange Fund, with reported total assets of HK$173.2bn as of the end of December 2021. This CLO transaction will be managed by the Infrastructure Financing and Securitisation Division (IFS) of HKMC.

The issuer issued five classes of rated notes: Class A1, A1-SU, B, C and D Notes. The Class A1 notes and Class A1-SU notes rank pari passu with each other and rank senior to the Class B, C, D and the unrated subordinated notes.

In addition, the issuer issued unrated subordinated notes to HKMC that receive only residual interest and principal payments. HKMC provided a sponsor loan to the issuer at closing to support the liquidity of the issuer in meeting interest payments on the rated notes on the first payment date.

Dr. Stan Ho Ho Ming

Executive Committee Member,
Asia Pacific Structured Finance Association (APSA)

LinkedIn: www.linkedin.com/in/stan-ho-6794859

External review of Bauhinia ILBS 1 Limited Sustainability Tranche

DNV Business Assurance Singapore ("DNV") was commissioned by HKMC to provide a pre-issuance eligibility assessment of the Sustainability Notes. DNV's objective was to provide an assessment that the Sustainability Notes have met the criteria established on the basis set out below.

The scope of DNV's opinion is limited to the Green Bond Principles ("GBP"), Social Bond Principles ("SBP") and

Bauhinia ILBS: rated and unrated notes issued **Exhibit 2**

Class	Ratings	Amount (USD mm)	Capital Structure	Effective Subordination	Pricing
A1-SU	Aaa (sf)	100.00	74.0%	26.0%	SOFR + 160bps
A1	Aaa (sf)	199.60			SOFR + 170bps
B	Aa1 (sf)	36.50	9.0%	17.0%	SOFR + 160bps
C	A2 (sf)	18.25	4.5%	12.5%	SOFR + 160bps
D	Baa3 (sf)	10.00	2.5%	10.0%	SOFR + 160bps
Sub	Not rated	40.43	10.0%	N/A	SOFR + 160bps
		404.78	100.0%		

Source: Moodys

Sustainability Bond Guidelines ("SBG") issued by the International Capital Markets Association ("ICMA").

DNV has provided a pre-issuance eligibility assessment on the Sustainability Notes:

1. Use of Proceeds: The Issuer intends to use the proceeds of the Sustainability Notes to finance and refinance Green projects and assets including Solar Energy projects, Wind Energy projects, Run-of-River hydro projects; and/or to finance and refinance Social projects and assets including Education projects and telecommunication projects. DNV has reviewed evidence that demonstrates that the Green and Social projects and assets for the issuance of Sustainability Notes meet the eligibility criteria specified in the Framework.

2. Principle Two: Process for Project Evaluation and Selection: The raised proceeds will be allocated to finance and refinance the assets as set out under Use of Proceeds. DNV has reviewed evidence that demonstrates that HKMC regularly assesses opportunities for improvement and devises action plans and initiatives to mitigate negative environmental and social impacts from its operations.

3. Management of Proceeds: The HKMC as the collateral manager of the Issuer, shall establish an independent allocation register to record and track the allocation of the proceeds from the issuance of Sustainability Notes. The full amount of the proceeds will be deposited in the accounts of the Issuer, and not be commingled with general accounts of HKMC, and an amount equal to the net proceeds will be earmarked for allocation to the eligible loan portfolio. HKMC will review the outstanding balance of the Sustainability Notes as part of its allocation reporting at least on an annual basis.

4. Reporting: HKMC has confirmed that it will report on its website the following:

i) The total amount of proceeds allocated to Eligible Loans;
ii) Description of selected allocated Eligible Loans;
iii) The balance of unallocated proceeds (if any);
iv) The amount or the percentage of new financing and refinancing;
v) Impact Reporting to a range of metrics as available and as selected.

It is DNV's opinion that the proposed Sustainability Notes meet the criteria established in the Protocol and are aligned with the stated definition of green/social/ sustainability bonds within the GBP, SBP and SBG.

Significance of Bauhinia ILBS 1 Limited Sustainability Tranche

Investors in this transaction include multilateral, local and international financial institutions, insurance companies and asset managers, as well as the Asian Infrastructure Investment Bank ("AIIB"), which participated as an anchor investor.

Since the global financial crisis in 2008, there has not been a publicly listed securitisation in Hong Kong, and there isn't one listed on Hong Kong Stock Exchange using a Hong Kong SPV. This transaction has helped put Hong Kong on the map in terms of its development into an infrastructure financing and securitisation hub.

Most importantly, the A1 sustainability tranche achieved a 10bps greenium compared with the A1 non-sustainability tranche, which strongly demonstrates the cost saving a green and sustainable securitisation can achieve for the issuer. This provides solid evidence for future originators considering green infrastructure securitisation.

Green infrastructure securitisation development in Asia

The path for green infrastructure securitisation in Asia Pacific is still at an early stage, but it is important for the runway to be laid in order to ensure that APAC does not miss out on potential growth opportunities.

Implementing green infrastructure projects would require emerging countries in APAC etc. to change the way they approach infrastructure planning. Equally, the benefits of green infrastructure securitisation must be emphasised to Asia Pacific, especially given how sustainable infrastructure is associated with expensive, costly projects.

While multiple factors and reasons are driving the rise of sustainable infrastructure financing from different angles, one important factor required for the successful implementation of sustainable infrastructure will be the creation of partnerships between private and public sector stakeholders in the infrastructure ecosystem.

Such partnerships are already being formed in the Singapore ecosystem, for both soft and hard infrastructure. This showcases the ability to lay the runway for green infrastructure securitisation to truly take off in APAC.

Contact us:

Asia Pacific Structured Finance Association (APSA)

Secretary-General: Prof. Kinglsey Ong

8th Floor, Nexxus Building

41 Connaught Road Central

Hong Kong

Email: kingsley@apsa-asia.com

Web: www.apsa-asia.com

Developments in the Swiss securitisation market

by Lukas Wyss and Maurus Winzap, Walder Wyss Ltd

THE PUBLIC AND PRIVATE SWISS SECURITISATION AND ABS MARKET HAS PROVEN TO BE RELATIVELY ROBUST AS COMPARED TO OTHER DEBT MARKETS. IT IS CLEAR THAT SECURITISATION AND ABS TRANSACTIONS CONTINUE TO BE AN IMPORTANT TOOL FOR THE PURPOSES OF DIVERSIFYING FUNDING SOURCES.

In situations of market disruption, certain funding sources might become more expensive or might not be available at all. Also, whilst the arbitrage between interest rates for ABS and straight bonds was not appropriate during the low interest period, there are reasonable grounds to believe that this will change as central banks are increasing policy rates.

Overview

In April 2021, AMAG Leasing AG closed a public Swiss auto lease ABS transaction involving the issuance by Swiss Car ABS 202-1 AG of CHF200m Notes with a coupon of 0.50%, due in 2031.

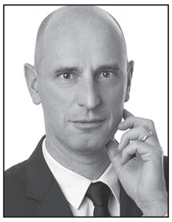
In June 2021, Swisscard AECS GmbH closed a public Swiss credit card ABS. The transaction involved the issuance by Swiss Credit Card Issuance 2021-1 AG of CHF190m 0.350% Class A Notes, CHF6m 1.000% Class B Notes and CHF4m 2.375% Class C Notes (all with a scheduled redemption date in 2024).

In June 2022, Swisscard AECS GmbH closed a public Swiss credit card ABS. The transaction involved the issuance by Swiss Credit Card Issuance 2022-1 AG of CHF190m 0.350% Class A Notes, CHF6m 1.000% Class B Notes and CHF4m 2.375% Class C Notes (all with a scheduled redemption date in 2024).

In November 2022, AMAG Leasing AG established a new auto covered bond program and issued an initial tranche CHF260m 0.00% due 2025; further issuances followed.

A number of mortgage-backed covered bond transactions have been brought to market. As an example, in September 2022, Corner Banca SA established its new covered bond program and issued an initial tranche CHF100m 2.25% fixed rate notes due 2027.

Lukas Wyss



Maurus Winzap

Lukas Wyss
Direct phone: +41 58 658 56 01
lukas.wyss@walderwyss.com
Fax +41 58 658 59 59

Maurus Winzap
Direct phone: +41 58 658 56 05
maurus.winzap@walderwyss.com
Fax +41 58 658 59 59

A number of private ABS transactions (i.e. transactions that are refinanced through ABCP platforms or through direct investors or banks) have been extended and renewed. Also, the number of trade receivable securitisation transactions involving Swiss receivables and/or Swiss sellers remained stable.

There is considerable activity in new asset categories, such as royalty cash flows securitisations, asset subscription securitisations and others. All of these transactions are, however, set up as non-public transactions.

Finally, there appears to be a lot of dynamic in the residential mortgage loan space. Various players in the market seek at refinancing their mortgage loan portfolios. Structures that have been implemented include one-to-one refinancing transactions, fund structures, pension funds structures and others.

Also, originators are looking at covered bond transactions and in addition to those covered bond issuers already present in the market, it can be expected that a number of additional transactions will come to market during the next 12 months.

Increasing interests

During the last couple of years, corporate and government bonds provided for very low coupons and yields. In addition, under the Swiss prospectus regime, straight bonds can be issued very efficiently and time to market is very short. Hence, transaction costs are considerably lower. Finally, for asset managers, unsecured bonds are simple instruments and internal processes for getting to an investment decision are very efficient.

On the other hand, securitisation transactions and ABS are slightly more complex. Transaction costs are higher and time to market is, even for repeating issuers, significantly longer. Also, the process for asset managers to get to an investment decision is normally more burdensome.

As a result, issuers and investors focused on straight bonds and, consequently, the pricing on straight bonds was very attractive. ABS transactions, even with AAA senior tranches, priced relatively high. Markets did not correctly price the higher rating and the lower risk profile of the ABS.

Since June 2022, the Swiss National Bank has increased the policy rate from -0.75% to -0.25% in a first step and to +0.50% in a second step.

It is a fair expectation that higher interest rates are likely to restore an appropriate arbitrage between straight bonds and ABS. Also, it continues to be important for issuers under securitisation transactions and ABS to continue to be present in the ABS market and to continue being diversified.

The Covid-19 pandemic and other disruptive events in the past have shown that securitisation transactions and ABS are a stable and reliable source of funding.

New prospectus regime and listing rules

In a general attempt to bring the Swiss regulatory framework in line with international regulations, such as MiFID II and the EU Prospectus Directive, the Financial Market Infrastructure Act (FinMIA), the Federal Financial Services Act (FinSA) and the Financial Institutions Act (FinIA) replaced major portions of the previous regulations.

The FinSA and the FinIA entered into force on January 1, 2020, along with the explanatory Financial Services Ordinance (FinSO, relating to the FinSA) and the Financial Insititutions Ordinance (FinIO, relating to the FinIA).

For the first time in Switzerland, the FinSA introduced a new comprehensive prospectus regime that covers and harmonises disclosure requirement for different types of financial instruments and establishes a level playing field with the EU Prospectus Directive. This also affects the issuance of instruments to the capital markets in securitisation transactions.

Following the designation of BX Swiss AG (the Berne Stock Exchange) and SIX Exchange Regulation AG (Zurich) by FINMA to act as prospectus review bodies, the new prospectus regime mandatorily applied since December 1, 2020.

Initially, there have been some uncertainties about the practical aspects of the prospectus approval process, but it turned out that the approval process is relatively slim and the reviewing bodies, as contemplated by the relevant legislation, are applying a very formal approval regime (i.e. there is no review of the prospectus as to substance). Thus, some initial uncertainties around the format of the prospectuses and the practical elements of the process have been eliminated.

As the Swiss regime treats securitisation transactions, including asset backed securities like bonds, prospectus for securitisation transactions generally have to meet the requirements of a prospectus for bonds. Still, a number of special rules apply to securitisation transactions.

Disclosure rules (prospectus) as per the Swiss Financial Services Ordinance: In addition to the general prospectus requirements, a prospectus for ABS must contain certain additional disclosure information:

- Transaction summary that summarises the key elements and characteristics of the transaction structure, the risks associated to the investment in the notes (by reference) and the possibility and manner how to enforce the investors' rights;
- Reference to the detailed information in the prospectus and description of transaction documents;
- Transaction overview, including:
  - key elements of transaction structure, transaction parties, interests of parties involved, cash flows, credit enhancement and early amortization events and events of default;
  - description of assets that back the notes and associated risks;
  - three year historical data on asset pool, including delinquency and default rates and information on the advance rate, risks, including counterparty risks;
  - legal risks;
  - other significant risks related to the structure and the asset pool.

There remain a number of uncertainties for securitisation and ABS transactions. As an example, the FinSO requires issuers to disclose in the prospectus the financial statements of the past two years. There is not really a clear exemption for securitisation SPVs, but given that ABS is explicitly referred to in the FinSO, it must be concluded that not disclosing such financial statements is permissible, if not available.

Also, the FinSO requires newly incorporated issuers to disclose in the prospectus an audited opening balance sheet. Normally, in the context of a securitisation or ABS transaction, assets are only transferred to the issuer on settlement.

Accordingly, the opening balance sheet only shows the (initial) paid in capital and a small amount of cash and that information is obviously not relevant at all for investors to make an investment decision.

Still, as the requirement is quite explicit, most issuers have so far decided to go through the process of auditing the opening balance sheet of the issuing SPV and disclose it in the prospectus.

Three-year track record and minimum equity capital. According to the listing rules issued by the SIX Swiss Exchange, an issuer of debt securities must be pre-existing for three years. However, ABS issuers (which are typically newly incorporated SPVs) benefit from an exemption. According to the listing rules issued by the SIX Swiss Exchange, an issuer of debt securities must have a minimum equity capital of CHF25m. However, ABS issuers benefit from an exemption and that requirement does not apply.

Tax

10/20 non-bank rules – Political developments and the public vote of September 2022. Under the current Swiss withholding tax regime, 35% Swiss Federal withholding tax is levied on interest paid to Swiss or foreign investors on bonds and similar collective debt (including ABS). It should be noted that any financing (including credit financings) may be subject to such a treatment in the event that the number of non-bank creditors under such a financing exceeds ten.

On April 3, 2020, the Swiss Federal Council initiated a consultation process (Vernehmlassung) regarding a planned reform of the Swiss Federal withholding tax. The reform originally intended to replace the current debtor-based regime applicable to interest payments with a paying agent-based regime for Swiss Federal withholding tax.

As a consequence of the consultation process, the Swiss Federal Council, on September 11, 2020, decided to abolish Swiss withholding tax on interest payments (with the exception of interest payments on domestic bank accounts and deposits to Swiss resident individuals) without substitution and it submitted a corresponding legislative project to Parliament on April 14, 2021.

The abolition of Swiss withholding tax on bonds and other collective debt financings aimed to strengthen Switzerland's position as a financial market and treasury centre.

All types of financing and refinancing activities in Switzerland (eg, raising capital via bond issuances, crowdfunding platforms, ABS structures and other capital market transactions) would have been facilitated.

A referendum was initiated against such a legislative project (and the abolition of the Swiss withholding tax on interest payments) and the project therefore brought to a public vote by the people of Switzerland. On September 25, 2022, the Swiss people declined the new legislative project with 52% of voters being against the reform.

Accordingly, the Swiss withholding tax regime remains unchanged, and it is worthwhile summarising the current regime again.

10/20 non-bank rules – Swiss withholding tax. Unlike most other countries, under the current Swiss withholding tax regime, Switzerland does not levy withholding tax on interest paid on private and commercial loans (including on arm's-length inter-company loans). Rather, 35% Swiss Federal withholding tax is levied on interest paid to Swiss or foreign investors on bonds and similar collective debt instruments issued by or on behalf of Swiss resident issuers. According to the Swiss Federal Tax Administration and the relevant regulations, credit facilities also qualify as collective debt instruments, if syndicated outside of the banking market and, as a result, there are more than 10 non-bank lenders in the syndicate.

International capital markets do not typically respond well to bonds subject to Swiss withholding tax. Therefore, the investor base is relatively often limited to Swiss investors, or, in the case of Swiss multinational groups, bonds are issued through a foreign subsidiary.

However, the Swiss Federal Tax Administration reclassifies such foreign bonds into domestic bonds if the amount of proceeds used in Switzerland exceeds certain thresholds (i.e., the combined accounting equity of all non-Swiss subsidiaries of the Swiss parent company and the aggregate amount of loans granted by the Swiss parent and its Swiss subsidiaries to non-Swiss affiliates).

Swiss withholding tax may be structured away in case a single entity is interposed between the Swiss originator/issuer and the investors. However, this entity must qualify as real (single) counterparty and be confirmed as such by the Swiss federal tax administration by tax ruling confirmation.

In that case, the transaction would no longer qualify as a collective debt funding, but rather as single counterparty transaction. In case it is not qualified as real (single) counterparty, the Swiss federal tax administration would apply a look through approach and the issue of Swiss withholding tax would arise again.

Typically, an entity is regarded as real (single) counterparty in case it is pre-existing (i.e. it has not been incorporated for purposes of a specific transaction), several transactions have been or will be set up using that counterparty and the volume of (expected) transactions is substantial as compared to the volume of the relevant single transaction.

As mentioned, that analysis must be confirmed by a tax ruling issued by the Swiss federal tax administration on a case-by-case basis for each single transaction. From experience, pre-existing conduit platforms, ABCP platforms, funds and similar counterparties would qualify as real (single) counterparty for tax purposes and tax rulings have been confirmed regularly in such situations.

Contact us:

Walder Wyss Ltd

Seefeldstrasse 123

8034 Zurich, Switzerland

Tel: +41 58 658 58 58

Web: www.walderwyss.com/en

ESG securitisation: accelerating after a slow start

By Andrew Bryan, Adam Craig and Julia Tsybina, Clifford Chance

Financing that takes into account environmental, social and governance ("ESG") factors has steadily been gaining prominence for several years. Investors across the board are increasingly seeking products which are not only financially robust, but which are also aligned with the broader ESG agenda. The best way to adapt securitisation to address ESG concerns has been a question for some time and has recently been looked into by the European Banking Authority in its report on "Developing a Framework for Sustainable Securitisation" (the "EBA Report")[1].

This article will explore the evolution of ESG concerns in securitisation from both a regulatory and a market perspective. It will look at the place of securitisation in the broader range of financing tools seeking to achieve positive ESG outcomes, as well as the challenges and opportunities it is facing.

General background

It is hard not to notice that ESG investment is booming – hardly a day goes by without ESG news in the main financial press. According to research from Bloomberg[2], ESG assets are forecast to represent a third of global assets under management by 2025. ESG financing figures for 2021 published by AFME[3] show the upward trend of new ESG bond and loan issuances. ESG bond and loan issuance volumes for the financial year 2021 were €749.8bn, up significantly from €396.4bn in 2020. While ESG securitisation issuances also increased in 2021 to €8bn (up from €2.1bn issued in 2020) with a mix of asset classes comprising consumer asset-backed securities and residential mortgage-backed securities, ESG securitisations still only made up 1.07% of ESG bond and loan issuances.

As these figures demonstrate, ESG securitisation volumes remain relatively modest as a proportion of the overall green and sustainability-linked financing market. One of the reasons for this may be a lack of a single, clear standard used to determine when securitisations meet ESG standards. As the EBA Report points out, there are at least three types of frameworks that are used to determine this, including (i) whether the securitisation is backed by ESG assets; (ii) whether the proceeds of sale of the assets into the securitisation will be used for some ESG purpose by the seller; and (iii) whether the key counterparties to the transaction commit to achieving certain sustainability-related KPIs. There is a further question about what counts as ESG or sustainability-related in the context of a securitisation.

This confusion about what metric to use for determining if a securitisation "counts" as ESG can make it even more difficult to meet those requirements. As alluded to in the EBA report, even a securitisation that qualifies as ESG purely on the basis of green use of proceeds by the originator/seller may – for purely reputational reasons – want to make sure that the assets backing it meet some kind of a minimal ESG standard (something akin to the "do no significant harm" principle from the EU Taxonomy Regulation) so as not to put off investors who may not wish to fund an "ESG" investment backed by e.g. high-emissions diesel cars.

Another reason ESG securitisation may not have got much beyond the starting blocks is that – to the extent the relevant standard is a securitisation backed by ESG-aligned assets – there is a clear lack of supply. Even where there are some clear options for how securitised assets could meet ESG criteria (e.g. excellent EPC ratings for homes financed in an RMBS or low emissions/electric cars for auto ABS), the inventories of these assets aren't sufficient to form the basis of a vibrant, liquid ESG securitisation market now. The EBA Report expresses concerns about this and it would seem from its Opinion on the proposal for an EU Green Bond Standard[4] that the ECB shares these concerns, although it expresses them less explicitly. We explore this issue further below.

Nonetheless, ESG securitisation as a tool for financing pools of assets, as opposed to financing corporates, is definitely gaining momentum. The first ESG securitisations started to appear in the European market from about 2017-2018 and quickly grabbed the headlines, and it is a testament to potential of this market that the IFLR structured debt deal of the year award for 2021 went to North Westerly VI ESG CLO managed by NIBC Bank.

What has happened so far?

There have been very few ESG asset securitisations in the main consumer asset classes to date. As mentioned above, other types of ESG financing, including corporate bonds and use of proceeds ESG covered bonds and, in the securitisation space, CLOs have led the way. This is partly because those deals are not limited on the supply side by availability of ESG assets the way securitisation would be. The most significant ESG securitisation deals we've seen in Europe so far have been the Green Storm RMBS issuances in The Netherlands, the Gemgarto Social RMBS, and Finsbury Square Green RMBS (both UK deals for Kensington) in the first half of 2021. Others are expected to follow.

While Green Storm is not explicitly linked to a set of ESG principles, the UK RMBS transactions of 2021 (including Yorkshire Building Society with Brass No.10) have chosen to align to the ICMA Green Bond Principles and the ICMA Social Bond Principles. For the Kensington transactions, the arrangers also took on an ESG structuring bank role, providing investors with soft comfort of third-party involvement in the process alongside the second party opinion provider who provides an opinion on the transaction and its economic sponsor (originator, in these cases), including benchmarking the use of proceeds, the asset selection and the originator's internal sustainability framework against external standards such as the ICMA Green Bond Principles.

Because of low levels of ESG asset availability, though, these deals have had to rely in large part on green use of proceeds by the originator, rather than green assets being used to fund the deal. For example, in Finsbury Square Green 2021-1, Kensington securitised £68m of green loans and committed to use the proceeds of the remainder of the class A notes to originate a further £570m of green mortgages over the following 5 years.

On the social side of ESG, market participants are still grappling with what it means to be a social securitisation. Clearly alignment to ICMA Social Bond Principles is workable, as Kensington showed with its Gemgarto 2021-1 issuance where the social project was making home loan finance available to applicants who are underserved by high street lenders using automated scoring processes given the complexity and characteristics of their income. Clearly the near-prime consumer credit market fits this bill squarely, especially with the use of credit builder products designed to improve or rehabilitate people's credit scores providing a ladder to prime products and rates in the future. The question remains whether this part of the market will seek to relabel itself as social. That, in turn, raises the question of whether relabelling of what is already happening as "social lending" will drive increased overall lending in underserved markets and drive greater energy efficiency in housing stock. Only time will tell.

Opportunities and challenges

The relatively modest size of the ESG securitisation market on the one hand and the ever-increasing investor demand for ESG investment opportunities across a broad range of debt products, from loans to securitisations, on the other present a clear opportunity for future growth of ESG securitisations. Indeed, recent research continues to demonstrate that investor demand in this space outstrips supply. Feeding into this trend is, among many other things, recent credit research demonstrating signs of positive correlation between the long-term viability of businesses and assets and its alignment with environmental, social and governance best practices.

While creating unique opportunities for growth of ESG securitisations, increased investor demand – combined with the relative under-development of the ESG securitisation market – creates two sets of challenges.

First, a lack of eligible collateral and verifiable, easily comparable, high-quality information in respect of existing portfolios pitched against the heightened investor demand create risks of greenwashing and associated reputational concerns.

Second, the understandable desire on the part of investors for more standardisation, transparency and verification and the associated push for more regulation which would remove, at least to a degree, the risks of investing in something which is an ESG securitisation in name only, is juxtaposed against the risk of creating an overly regulated landscape with overlapping and conflicting frameworks, and the associated potentially prohibitive compliance costs.

Balancing between factors and considerations which are often pulling in opposite directions is probably the main challenge faced by the ESG securitisation market at the moment. Leaving the area completely unregulated and relying solely on the market initiatives is not an option which realistically remains on the table, given the relative complexity of securitisation as a financing tool and the multiplicity of regulatory frameworks already in place and in the pipeline. On the other hand, creating too much regulation – or putting relatively rigid regulation in at too early a stage – would hamper development of the ESG securitisation market and work against the objective of unlocking its potential in delivering funding to ESG-aligned goals and opportunities in sectors where other funding tools may be unavailable or commercially unattractive.

These challenges suggest that – at least for an initial period – a "use of proceeds" paradigm for ESG securitisation may be the best way for the market to prioritise ESG concerns while building up the stock of ESG-aligned assets needed to build a robust ongoing ESG securitisation market that can be backed by ESG-aligned assets.


Andrew Bryan


Adam Craig


Julia Tsybina

Andrew Bryan - Knowledge Director
London
T: +44 20 7006 2829
E: Andrew.bryan@cliffordchance.com

Adam Craig – Partner
London
T: +44 20 7006 8862
E: adam.craig@cliffordchance.com

Julia Tsybina – Counsel
London
T: +44 20 7006 4368
E: Julia.tysbina@cliffordchance.com

Indeed, as mentioned above, the EBA Report acknowledges the concern about a lack of ESG-aligned assets as well as the concern about regulating too heavily and too early. Its main conclusion is that it is too early to put in place a specific framework for sustainable securitisation, preferring instead to recommend adjustments to the proposal for an EU Green Bond Standard to make it workable for securitisations – mainly by applying the issuer obligations set out in the proposal at the originator level, at least initially. This would have the effect of applying a "green use of proceeds" standard for ESG securitisation and provide an opportunity to build up a stock of ESG-aligned assets to grow a vibrant ESG securitisation market in Europe.

Regulatory framework and market initiatives

When looking at the current framework for ESG securitisation, it is worth noting that the more developed segments of the green, sustainability-linked and ESG finance markets have evolved over time from much the same place, as largely "bottom-up" driven, voluntary market initiatives. In the bond world, the main set of initiatives has been the ICMA Principles – including the Green Bond Principles, the Social Bond Principles and, more recently, the Sustainability-Linked Bond Principles.

Some of the challenges facing the ESG securitisation market – like the lack of standardisation, verification and consistency of information and greenwashing concerns – are also not unique to securitisation.

The EU Taxonomy Regulation seeks to address some of these concerns by creating an overarching common language for discussing ESG concerns, targets and KPIs, thereby facilitating a shared understanding among corporates, financiers, policymakers and regulators. The EU Taxonomy Regulation is an important example of the clear shift from industry-led initiatives to regulation in the determination of what counts as ESG, and securitisation is no exception to that trend. This has the potential to be a positive development, but in order for that to be true, policymakers will need to ensure that they do not move too quickly or make the criteria too difficult to comply with, with the result that they end up choking off a nascent market before it can flourish. The pieces of regulation and upcoming regulatory initiatives relating to ESG securitisation can be divided into "buy side" and "sell side" regulation. We consider each below.

"Buy side" regulation

In the EU, the main piece of regulation which establishes the framework for both entityand product-level disclosures applicable to asset managers is the Sustainable Finance Disclosure Regulation (or "**SFDR**")[5]. While its application to securitisations has largely been limited to CLOs to date[6], it is quite clear that this piece of regulation plays an important in setting the ESG agenda for financial investor community as a whole, including investors in securitisations. Unsurprisingly, an increased number of investor ESG deal requests coincided with the roll-out of the SFDR for precisely this reason.

It should be noted that while the SFDR represents an important milestone in creating a standardised and predictable playing field for sustainability disclosures, both at the entity and product levels (in the case of the latter, by linking up with the EU Taxonomy), its requirements are sometimes difficult to apply to securitisations. This is because the SFDR often assumes a degree of control over the information flows which is more typical of a private equity relationship than of a fund investing in broadly distributed, traded debt or consumer assets.

The recent proposal by the European Commission for a Corporate Sustainability Reporting Directive ("**CSRD**") is looking to significantly expand the scope of entities subject to sustainability reporting obligations to plug this gap in respect of corporate loans by ensuring that companies report the information which is required by investors and other market participants who are subject to the SFDR.

Similarly, although the EU Taxonomy Regulation represents a crucial step towards creation of a single sustainability "vocabulary" in Europe, it is also not always easy to apply to securitisations.

The UK did not on-shore the SFDR as part of its post-Brexit process. However, a framework mandating certain ESG disclosures for financial investors is also being introduced in the UK as part of the Green Finance Strategy adopted by the UK Government in 2019.

In June 2021, FCA published two consultation papers on climate-related disclosures. One proposed climate-related disclosure requirements for asset managers, life insurers and FCA-regulated pension providers with the aim of introducing mandatory climate-related disclosures across the UK economy and of integrating the recommendations of the Task Force on Climate-related Financial Disclosures. Another consultation focused on disclosures by listed companies, but also included a broader fact-finding request seeking views on ESG prospectus disclosure for debt securities and possible regulatory oversight of third party ESG verifiers and ESG rating agencies[7].

The policy statement on climate-related disclosures by regulated entities, as well as a final version of the ESG Sourcebook, was published in December 2021. The first disclosures under the new rules will be required by June 2023. Additionally, onshoring of the EU technical screening criteria, as well as to the international alignment issues, are also under consideration as it is viewed as important that any UK taxonomy recognises international standards due to the global nature of the issue of sustainability.

"Sell side" regulation

On the sell-side, the main regulatory initiative is the proposal for an EU Green Bond Standard ("**EUGBS**"). This proposal was largely inspired by the ICMA Green Bond Principles but was designed to give it formal regulatory status. The EU Green Bond Standard proposal picks up many of the Green Bond Principles, including taking a "use of proceeds" approach, requiring extra reporting on the "green" aspects of the transaction, and requiring external verification. It is also explicitly meant to include securitisation bonds.

That said, the original Commission proposal for an EUGBS is not especially well-adapted to securitisations, imposing most of the relevant obligations at the level of the bond issuer in a way that would be inappropriate for many SPV securitisation issuers and failing to clarify how the proposal's use of proceeds approach should apply to securitisations. These have been the securitisation industry's chief criticisms of the EUGBS proposal, and they have also been raised in the ECB Opinion and the EBA Report. With any luck, then, the proposals will be amended by the Council, the Parliament or both before the end of the legislative process on the EUGBS so that the final legislative outcome is better adapted to the needs of the securitisation markets.

In addition to the EUGBS there are a number of initiatives both in the EU and the UK which are looking at securitisation as a financial product and, more specifically, at the framework for enhanced ESG disclosure for securitisations. Both the EU and the UK consultations on reviews of their respective Securitisation Regulations at the end of last year included ESG questions intended to solicit market feedback on the best approach to such disclosure.

While the market views these initiatives as generally positive, the feedback received as part of the consultation processes, both in the EU and in the UK, uniformly encouraged a cautious and carefully balanced approach to requiring further ESG disclosure for securitisations. The resulting UK report suggested that HM Treasury has limited appetite for a specific sustainability framework just for securitisations. Given that we understand the equivalent Commission review report has been delayed in order to allow the EBA Report to be published, we currently expect that the EU will go in the same direction and focus its energies on the EUGBS and on the existing mandate for sustainability information to be published as part of the general Securitisation Regulation disclosure obligations (albeit this may be expanded to all securitisations rather than being restricted to STS securitisations as originally envisaged).

Lastly, given the increased focus on ESG, it is likely that the upcoming regular review of the EU Prospectus Regulation will consider green and sustainable bonds as part of the Strategy for Financing the Transition to a Sustainable Economy EU.

Conclusion

ESG finance in general and ESG securitisation in particular without doubt represent a significant, and ever growing, segment of the financial markets. Opportunities presented by ESG securitisation are important not only from the perspective of unlocking financing to those segments of the financial infrastructure which cannot tap into the traditional bond or loan markets but which nonetheless require investment aligned with the ESG objectives, but also – ultimately – from the perspective of achieving the climate change goals. Careful balancing of the competing demands and objectives in this space will be key to unlocking the full potential of ESG securitisations.

A version of this article was originally published on Clifford Chance's website and is reprinted here with the kind permission of the firm.

Notes

1. https://www.eba.europa.eu/eba-recommends-adjustments-proposed-eu-green-bond-standard-regards-securitisation-transactions
2. Bloomberg Intelligence, "ESG assets may hit $53 trillion by 2025, a third of global AUM", available at: https:// www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/
3. AFME, "ESG Finance Q4 and Full Year 2021 - European Sustainable Finance" available at: https://www.afme. eu/Publications/Data-Research/Details/-ESG-Finance-Q4-and-Full-Year-2021---European-Sustainable-Finance
4. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52021AB0030&from=EN (the "ECB Opinion")
5. Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability – related disclosures in the financial services sector
6. Securitisation products in general are not "financial products" for the purposes of SFDR and are therefore not regulated under it.
7. See further ESG publications at https://www.cliffordchance.com/expertise/services/esg/esg-insights.html.

Contact us:

Clifford Chance

10 Upper Bank Street

London, E14 5JJ

Tel: +44 (0) 20 7006 1000

Web: www.cliffordchance.com

Demand for US data centre and clean energy securitisation in 2024

By John Hwang, Derek Poon and Josh Kopel, Allen & Overy LLP

As traditional asset-backed securities markets continue to be affected by macroeconomic factors that have curtailed the securitisation capital markets, broader macro trends have continued to suggest continued demand and growing popularity in non-traditional asset classes such as data centre receivables, PACE loans, and solar assets.

Logging in: data centre securitisation

Undoubtedly, one of the most societally transformational events of the last fifteen years was the COVID-19 pandemic. And nowhere was that change more apparent than in the tech space. As offices across the globe became more familiar with Zoom, Webex and Teams than they might have ever imagined, a parallel demand—one for the power and data capacity to fuel the explosion of demand for cloud and other online services—made itself known. Data centres have become an increasing necessity, not only for industry giants like Google, Apple, Microsoft and Meta, but also for mid-size and smaller companies, whether or not part of the technology space. And with continued growth in artificial intelligence and other computing-heavy technologies, the outlook for data centres is one of further demand.

Like many industries faced with growing demand and a need to fund their operations and investments, data centre operators have increasingly turned to the securitisation market as one of the ways in which they finance their operations. In October 2023, Vantage Data Centres, for example, raised US$1.35bn in securitised notes. And earlier in the year, Stack Infrastructure closed two rounds of data centre ABS financing (with the latter closing with US$250m of securitised notes), while CyrusOne closed a US$701m issuance in April.

Data centre securitisations present some unique aspects for market participants compared to other traditional asset classes. For example, in evaluating the collateral and the cashflows of data centre securitisations, market participants have noted that data centres are physical buildings that operate for the purposes of transmitting data, thereby possessing characteristics of both commercial real estate and infrastructure, and while some revenue for the properties may come from leases, other cashflows may arise via service contracts (provision of equipment, power capacity, etc.).

Additionally, the asset class is relatively new, making for little in the way of historical data on which to base modelling and performance evaluation. Modelling and evaluation is also complicated by the fluctuation of power costs and demand not only across days, weeks and seasons, but also based on location, grid demand and local infrastructure. The ever-growing demand for data capacity means more and more data centre operators may look to the securitisation market to provide for financing. As the asset class develops and practice settles, the ease of carrying out data centre securitisations will likewise improve.

But what are some of the considerations for a data centre securitisation? First principles suggest a few important points:

First, geographical diversity. Geographically spread data centres ensure that natural disasters, local energy demand, commercial constraints and competition from other operators will have a reduced impact on the performance of a securitiser's asset pool even if one or more individual data centres see disruptions. In addition, locations should be selected with a mind towards proximity to the end customer markets of the tenants who use those data centres, thereby creating staging points for data traffic and increasing the strength of the operators' offerings to their clients.

Second, operational diversity in the type of operated data centre (whether wholesale, hyperscale, enterprise or colocation), which can offer similar benefits in terms of risk mitigation to geographical diversity. In particular, being able to provide a variety of offerings in terms of scale allows a data centre operator to pivot flexibly and adjust to changing client demands and potentially mitigate re-leasing risk.

Third, structural flexibility. Because the capacity demands for data centre customers may change over time and grow with the customer's own operations, securitisers of data centres may design their structure to permit some level of development and ongoing capital expenditure on the data centre sites so that they can cater to the needs of their clients. For the securitisation, it can be beneficial to structure in the flexibility to allow for future debt upsizes in the event other data centres are added to the pool down the line.

Fourth, long-term contracts, fee simple ownership of the property and well-rated tenants. Long-term contracts help reduce the risk associated with possible non-renewal by tenants; better still if the tenant contracts are staggered to address concentrated re-leasing risk. Likewise, fee simple ownership of the property reduces the risk inherent to a leasehold interest: that the property's landlord seeks to terminate or otherwise not renew the lease. Finally, having a tenant base with strong credentials (whether in terms of ratings, credit performance history in the data centre space, or otherwise) helps establish consistent cashflows desired in a securitisation.

So where are data centre securitisations likely to go from here? As the volume of internet traffic continues to grow, such structures are likely to become more common as existing operators grow in scale and new operators enter the space. In particular, hyperscale projects have the potential to be a growth-driver. Hyperscale tenants additionally offer the benefit of generally being higher-credit quality with stronger credentials.

Going green: PACE & solar securitisations

Like data centre securitisations, PACE and solar asset securitisations are also in growth mode, as financers, consumers and governments look to greener options as part of the global energy transition.

PACE

PACE (or Property-Assessed Clean Energy) financing is a somewhat unusual asset in that, unlike a more typical mortgage recorded on a property, it is generally recorded as a special assessment on the property tax records of the property on which PACE-eligible improvements have been made, and are accordingly paid along with the applicable property taxes on such property. These PACE programs in turn can be used by property owners to finance a wide variety of eligible improvements, including insulation; heating, ventilation, and air conditioning; efficient lighting; improved irrigation and water heating; and renewable energy production.

The resulting PACE assessment may or may not be junior to the real property tax in question depending on the specifics of the local PACE program, but—significantly—will be senior to any first-lien mortgage on the property. Another notable nuance is that a PACE assessment will remain with the property unless prepaid if such property is sold or refinanced. And unlike a mortgage, PACE assessments are not accelerated if left unpaid; instead they are due and payable out of foreclosure sale proceeds. PACE programs can generally be divided into two types: commercial (C-PACE) and residential (R-PACE).

C-PACE programs are operational in 38 US states, as well as the District of Columbia and cumulatively represent billions in energy efficiency projects being subsidised. R-PACE programs are active in 3 US states (California, Florida and Missouri).

C-PACE securitisations represent a unique asset class with its own benefits and challenges. On the one hand, being linked to municipal subsidy programs can increase deal complexity, requiring not only counsel familiar with such processes, but also documentation devoted to the municipal bonds or special tax assessments—a point which varies from C-PACE program to C-PACE program—that are linked to the underlying cashflows (payment rights under which are generally assigned to the securitisation via the entity that acts as PACE administrator for the jurisdiction in question).

All of this complexity also plays into the rating process, as rating agencies must consider not only the varied jurisdictional nature of the PACE funding programs (and their potentially idiosyncratic requirements) but the aforementioned security and payment nuances, as well as the variation in applicable servicing process, which is carried out in most cases by the local tax authority (though third-party servicing is not uncommon). For example, one consideration is whether or not the underlying PACE assessment or bond issuance has been subject to a validation proceeding (a type of in rem proceeding that can be brought in some states to validate certain actions of public agencies), after which point no further challenges can be made to invalidate the action on the merits through such process.

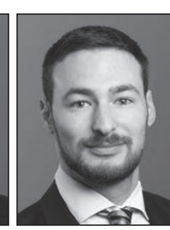
On the other hand, the involvement of local governments and their oversight at the origination stage can represent a potential comfort to investors that the origination process is being run subject to their oversight. And in the case of jurisdictions for which servicing is performed by the local tax authority, investors know that the same party (i.e. the government) which set the standards for PACE eligibility is the party engaging in the servicing of those same PACE projects. Moreover, rising energy prices and the uncertainty of climate change make green improvements like solar panels, energy-efficient insulation or lighting and reflective roofing attractive to home- and business-owners, and therefore a source of underlying cashflows for current and ongoing PACE securitisations.

But what comes next for C-PACE securitisations? Three states (Alabama, Vermont and New Hampshire) have C-PACE programs active but few or no funded projects, while three other states (Hawaii, New Jersey and New Mexico) are in the process of developing and implementing their own C-PACE program frameworks. That leaves the remaining thirteen states as open question marks. But with C-PACE programs active throughout the country, and across political and geographic divides, it may be likely that these states will eventually develop and implement their own C-PACE programs, at which point this would be a truly national asset class.

Less clear is the fate of R-PACE securitisation, which faces uncertainty as a result of regulatory pressure. In 2009, the

John Hwang

Derek Poon



Josh Kopel

John Hwang, Partner

Email: John.Hwang@allenovery.com

Tel: 212-756-6395

Derek Poon, Senior Counsel

Email: Derek.Poon@allenovery.com

Tel: 212-610-1165

Josh Kopel, Associate

Email: Joshua.Kopel@allenovery.com

Tel: 212-610-6356

then-director of the Federal Housing Finance Agency (which oversees Freddie Mac and Fannie Mae) penned a letter in opposition to the senior-lien nature of PACE assessments, highlighting what he considered to be attendant risks and expressing concern about risks for homeowners,[1] concerns which have been echoed by subsequent administrations. Fannie and Freddie have also indicated that they will not purchase mortgage loans secured against properties with PACE assessments attached to them.[2]

Separate from federal regulatory concern, there is also some uncertainty around consumer-protection law's application to R-PACE. In particular, R-PACE obligations do not seem to fit within the framework outlined by the Federal Truth in Lending Act (**TILA**) for consumer credit and mortgage loans. At least some certainty—although not without a corresponding price—may be on the horizon as the Consumer Financial Protection Bureau announced in May 2023 a proposed rule which, if promulgated in its current form, would, among other things, (i) require PACE creditors and PACE companies to consider a consumer's ability to repay when issuing a new PACE loan and (ii) amend Regulation Z to address how TILA applies to PACE transactions. While it remains to be seen, the certainty offered by such rule, if promulgated, could help solidify the ground for R-PACE securitisations.

Solar securitisations

Solar securitisations in the US primarily comprise of consumer residential assets in the form of residential solar loans and residential solar leases or power purchase agreements, though commercial and industrial assets have also experienced recent growth. Since the emergence of the asset class in 2013, the US solar securitisation market has experienced substantial growth.

Some of the appeal of consumer solar assets stems from the perceived benefits that solar assets demonstrate as compared to other consumer loans in that they are could be viewed as reducing the consumer's overall household electricity payment, creating consumer-side incentives to pay the solar loan to avoid higher utility expenses. Net metering also provides incentives for a consumer to pay their solar bills. Lastly, solar consumers are generally prime or near-prime obligors.

Additionally, government incentives should also stimulate the supply of solar assets. For example, in 2022, the Biden administration's signature Inflation Reduction Act (**IRA**) brought into law a bevy of benefits for solar providers and consumers; in particular, the IRA:

- Extended the Investment Tax Credit (which provides up to a base rate of 30% of one-time tax credits off the cost of the system or project) and the Production Tax Credit (which provides an annual tax credit based on the amount of energy produced and sold by a project), and for non-individuals, provided for add-on bonuses to the tax credits if certain criteria are met;
- Extended eligibility to stand-alone storage facilities and batteries; and
- Provides that parties claiming federal tax credits can transfer those credits.

Additional actions by government agencies also support the asset class. In September 2023, for example, the Department of Energy announced the closing of a US$3bn partial loan guarantee that will indirectly and partially guarantee the cash flows associated with consumers' loans in Sunnova Energy's securitisation transactions.

Moreover, solar ABS had a strong showing during the pandemic, demonstrating the resiliency of the asset class even amidst more challenging economic headwinds. Strong past performance, coupled with structural and governmental incentives, seems likely to drive growth in the solar space, which may in turn materialise into increased ABS activity as solar financers and providers seek to find a source of cost-effective financing.

Conclusion

A rapidly changing world means rapidly changing markets, and while the future is never certain, there is little question that technological expansion and green energy will have an increasing role in the securitisation markets.

Notes

[1] James B. Lockhart III, June 18, 2009, *"Letter from FHFA Director James Lockhart III to National Governors Association, National Association of Credit Union Supervisors, National Conference of State Legislatures, American Association of Residential Mortgage Regulators, and Conference of State Bank Supervisors."*

[2] See https://sf.freddiemac.com/general/refinancing-and-energy-retrofit-programs and https://selling-guide.fanniemae.com/Selling-Guide/Origination-thru-Closing/Subpart-B5-Unique-Eligibility-Underwriting-Considerations/Chapter-B5-3-Construction-and-Energy-Financing/Section-B5-3-4-Property-Assessed-Clean-Energy-Loans/1032996471/B5-3-4-01-Property-Assessed-Clean-Energy-Loans-12-16-2020.htm

Contact us:

Allen & Overy LLP

1221 Avenue Of The Americas,

New York, NY 10020

United States

tel: +1 212 610 6300

web: www.allenovery.com

European Commission report on the functioning of the Securitisation Regulation – a missed opportunity

By Julian Craughan, Steven Minke and Jane Griffiths, Hogan Lovells

On October 10, 2022, the European Commission published its long-awaited report on the functioning of the Securitisation Regulation. Whilst a number of helpful recommendations were made on the back of extensive market feedback, hopes for significant changes in a number of areas were not met. It is clear that there will be no legislative proposal in the near future and more targeted reforms continue to be needed in order to facilitate the recovery of EU securitisation.

Background

On October 10, 2022, the European Commission (**EU Commission**) published its long-awaited Report on the functioning of the Securitisation Regulation[1] (**EU Report**)[2].

The EU Report covers non-prudential matters[3], as mandated under Article 46 of the Regulation (EU) 2017/2402 (**Securitisation Regulation**). In particular, the EU Report fulfils the EU Commission's requirements under Article 45a (3) to report on a specific sustainable securitisation framework, taking into account the relevant European Banking Authority (**EBA**) report[4]. The EU Commission also addresses certain legal interpretation issues raised by the European Supervisory Authorities' (**ESAs**) opinion[5] of March 26, 2021 to the EU Commission on the jurisdictional scope under the Securitisation Regulation (the **Joint Committee Opinion**). It also takes into account the recommendations made by the high-level forum on the Capital Markets Union, created by the EU Commission in 2019.

A separate report[6] on prudential matters under Article 519(a) of the Capital Requirements Regulation (**CRR**) was published on December 12, 2022 (**Prudential Report**).


Julian Craughan


Steven Minke


Jane Griffiths

Julian Craughan, Partner
tel: +44 (0)20 7296 5814
e-mail: julian.craughan@hoganlovells.com

Steven Minke, Associate
tel: +44 (0)20 7296 2222
e-mail: steven.minke@hoganlovells.com

Jane Griffiths, Counsel Knowledge Lawyer
tel: +44 (0)20 7296 5386
e-mail: jane.griffiths@hoganlovells.com

Key points from the Report:

Risk retention

No changes were proposed but the EBA will continue to monitor the use of risk retention and in particular the rationale for usage of different methods.

Transparency and due diligence

It is encouraging that ESMA has been tasked with reviewing the disclosure templates; these are widely considered unfit for purpose and too prescriptive for private securitisation, especially given that the transaction parties usually benefit from a close working relationship and funders routinely request the level of detail and granularity of information they require from originators without resorting to the reporting templates. Disproportionate reporting has a cost impact for private securitisations which is certainly more than negligible. Indeed, our experience is that investors do not consider the statutory loan-level reporting in any detail, and it is unclear to what extent any supervisors rely on this. We are optimistic therefore that ESMA will, as part of its review, be pragmatic in removing unnecessary information and adopting a more proportionate approach.

Private securitisations

One of the biggest disappointments in the EU Report is the approach on private securitisations. Given recent market volatility and the important role private securitisations have played to date (including during the Covid-19 pandemic), it is a missed opportunity not to promote this segment of the market more fully and lighten its regulatory burden, particularly given its positive potential for the wider economy. A separate regime for private securitisations, not subject to prescriptive templated disclosure requirements, might have opened up this market, for which the current rules have provided overly prescriptive and inflexible for smaller market players and transactions.

The EU Commission, perhaps suspicious that private deals might be circumventing transparency requirements, wants more time to assess whether there has been a disproportionate rise in private deals. Consequently, the definition of private securitisation remains unchanged as the EU Commission believes that this issue can be dealt within the existing rules and templates. Instead, ESMA will be tasked with drawing up dedicated templates for private securitisations. It had been proposed that private transactions should not be subject to such template-based disclosure as the requirements are not justified by the nature of the risks and parties to bespoke private deals.

Consideration will also be given as to how information about private transactions should be made available and in the long term this could be via securitisation repositories though this would require a change to the level one text of the Securitisation Regulation. Some participants may welcome this, given that some originators and sponsors have opted to provide notifications of transactions which are technically private as public deals. This is driven by firms wanting to provide a detailed record of information that firms may want to be public but it would be another hurdle for private transactions to overcome if applied to all private transactions.

STS equivalence

Another disappointment in the EU Report is the lack of movement on STS equivalence meaning that EU investors will continue take a greater capital hit for non-EU STS transactions. No equivalence regime is proposed at this time as the EU Commission is not confident that other regimes can match the Basel standards, despite there being other jurisdictions that may have, or are considering adopting equivalent standards. The EU Commission will, however, keep STS equivalence under review so the door has been left ajar on this point.

Third party verification of STS criteria

No changes were proposed for third party verification which is seen to be functioning well.

Sustainable securitisation

It is welcome that the EU Commission adopted the EBA position[7] that, for now, no dedicated sustainability label for securitisations is proposed. Since the EU Report was published, we have seen that the EBA recommendations were taken into account in the final compromise text of the

Regulation on European Green Bonds (**EuGB**), which allows for a "use of proceeds" model relating to the originator or sponsor of a securitisation and also the with the publication of regulatory technical standards pursuant to Articles 22(6) and 26d(6) of the Securitisation Regulation (**Sustainability RTS**)[8]. The importance of environmental, social and governance (**ESG**) in European securitisations, and how to incorporate it within current and future frameworks, is clearly a focus for regulatory bodies and inevitably will result in heavier disclosure obligations. The regulators are cognisant of the existing reporting requirements to which securitisations are subject; whilst it may be that additional standardisation for disclosure in the market might assist in increasing market share for a product that has some way to go in meeting its full potential in contributing to the ESG agenda a careful, proportionate approach is needed so as not to create such a burden that it deters the ESG securitisation market from developing. It is worth noting that incorporation of ESG data could be included in the disclosure templates as part of the ESMA template review[9].

SSPEs

We are pleased to see that the proposal for a system of limited-licensed banks to perform SSPE functions was rejected by the EU Commission. This proposal was widely rejected by market participants, fearing it could jeopardise independence in control and management of the SSPEs and lead to a higher concentration of risk.

Jurisdictional scope

Some helpful clarification was included to address the significant market concern that has surrounded the extra-territorial impact of the Securitisation Regulation. In particular Articles 6 (risk retention), 7 (disclosure and transparency) and 9 (credit-granting criteria) and the inconsistency between Articles 5(1)(b) and 9 have been the source of some confusion.

The benefit of the Joint Committee Opinion was limited as the ESAs could not fully deal with matters of interpretation, change the legislation or give official guidance. This uncertainty has been an unsatisfactory position for the securitisation market, resulting in the EU securitisation market being less appealing to non-EU entities by subjecting them to EU obligations and resulting in lengthy negotiations between non-EU originators and EU financial institutions seeking to comply with their Article 5 obligations.

The EU Commission has clarified, as discussed below, that in some circumstances non-EU entities, whilst not subject to the Securitisation Regulation, may fulfil certain requirements, given that EU investors are required, nevertheless, to verify that the requirements of Articles 5, 6 and 7 have been fulfilled.

- ***Sell-side obligations***
  - **Risk retainer:** we now have clarity that a non-EU entity may act as risk retainer, though no amendment to the Securitisation Regulation is proposed on this point. This is a positive clarification given situations where it is not appropriate for an EU entity to act as retainer from a commercial perspective. If the EU Commission had required an EU entity to act as retainer in all circumstances this would limit a substantial proportion of transactions and might have required existing transactions to restructure or terminate, which would be counter to improving the securitisation market and less beneficial to the economy as a whole.[10]
  - **A non-EU-based originator, sponsor or SSPE can report but liability remains jointly with any EU-based entities:** a non-EU originator, sponsor or SSPE may be designated to fulfil the obligations of Article 7 of the Securitisation Regulation, which is sensible given that a non-EU entity may be the most appropriate entity. However, any EU-based originator, sponsor or SSPE nevertheless retains the joint legal obligation to disclose all the information requested by Article 7.
  - **Credit-granting criteria may be met by a non-EU entity:** very helpfully, the EU Commission has clarified that, whilst the optimum scenario would be that an EU entity would fulfil these requirements, the credit-granting criteria "can only be meaningfully met by the credit-granting entity in the process, regardless of whether or not it is located in the EU".

The EU Report notes that, in any event, an "EU-based investor is only allowed to invest in transactions for which it can be verified that they comply with the obligations of Article 9" and EU investors must be appropriately informed.

- ***Sponsor obligations***
  Article 5(1)(b): The EU Commission notes the inconsistency between Article 5(1)(b) and Article 9, whereby Article 5(1)(b) imposes on investors the obligation to ensure that the originator or original lender complies with the requirements of Article 9, whereas Article 9 applies to sponsors too. The EU Commission intends to resolve this matter in the next revision of the Securitisation Regulation but considers that this is not a problem that requires an urgent fix on the basis that if the sponsor "does not apply any credit-granting standards since it does not grant credit on its own account, Article 9(1) cannot in practice impose a valid direct obligation on the sponsor".

- ***Buy-side obligations – availability of disclosures***
  It is a shame that the EU Commission did not choose to provide needed clarity on Article 5(1)(e)[11], which has been a bone of contention on cross-border transactions for some time. An equivalence regime ensuring that EU investors would not be disadvantaged and could have relied on information in a different format would have been a fitting solution in our view. This is all the more surprising given that the ESAs had been in favour of an assumption of compliance for third-country securitisations, notwithstanding that not all of the Article 7 requirements would be fulfilled and recommended a 'third-country equivalence regime for transparency requirements'. Unfortunately market concerns as to the additional administrative burdens this places on both EU and non-EU parties remain and means that EU participants continue to be at a significant competitive disadvantage.

  The EU Commission may have felt constrained in this area as changes may have required modification to the level 1 text of the Securitisation Regulation and may provide clarifications in a future amendment of the Securitisation Regulation. For now, however, on the basis of affording the same protections for investments in non-EU securitisations, the market may have to rely on amendments to the technical standards relating to Article 7 to facilitate the provision of information from non-EU sell-side parties and any additional guidance. Until such time as any private securitisation templates are finalised however, investors in third-country securitisations are at a significant disadvantage with potentially material repercussions for the wider market.

  In light of this, further guidance has been sought by joint associations in their letter[12] "Request for guidance to national competent authorities to use enforcement powers in a proportionate and risk-based manner" dated 9 December 2022. AFME has also highlighted a number of issues, more generally, with Article 5 due-diligence requirements in its "Article 5 Issues Report Due-diligence requirements for institutional investors under Article 5 SECR" dated 14 June 2023.[13]

- ***Buy-side obligations – Alternative Investment Fund Managers (AIFMs) investors***
  The EU Commission confirms that non-EU AIFMs and "sub-threshold" AIFMs are within the scope of the requirements but that the Securitisation Regulation should only apply to funds that a third-country AIFM markets and manages in the EU. The EU Commission will consider amending the wording of Article 2(12)(d) to specifically remove any kind of legal uncertainty in a future proposal to amend the Securitisation Regulation.

Supervision of securitisation

Another hope was that reporting systems could be improved, considering different supervisory practices. The EU Commission considers that the overall supervisory framework is satisfactory but taking into account various matters raised in the review, considers that there is room for future guidance and co-ordination between supervisors.

Relevance for the United Kingdom

The United Kingdom on-shored the Securitisation Regulation with effect from January 1, 2021 (**UKSR**) with minimal changes. HM Treasury (**HMT**) undertook its own Article 46 review under the UKSR and published its equivalent Review of the Securitisation Regulation: Report and call for evidence response[14] (**HMT Report**) on 13 December 2021. Generally HMT believed that the UKSR functions well with the HMT Report making similar observations in relation to the use and growth of private securitisations, SSPEs, third party verifiers, and sustainability. A few changes were recommended and some of these are included in proposals for the replacement of the UKSR (**New Framework**)[15] as part of a new regime for the regulation of securitisation in the UK.

Of particular interest, in the context of the EU Report, we highlight below some of the areas mentioned in the HMT Report that are reflected in the proposed New Framework where there is some difference of approach with the EU.

- **Transparency and due diligence**. No changes are proposed at this time but a further consultation in this area is contemplated, including as to changes to the private and public disclosure templates, taking into account points discussed in the HMT Report. We will watch this space with interest and particularly for areas of divergence between the EU and UK regimes as they develop.
- **Private securitisations**. The FCA has mooted whether transactions defined as private securitisations should be subject to a less stringent, more proportionate reporting regime and a further consultation will consider which securitisations should be considered public and be required to report via a securitisation repository (unlike the EU Report which does not propose changes to the definition of private transaction).
- **STS equivalence**. Unlike the EU Commission approach, the New Framework contemplates an equivalence regime, noted as being "desirable" in the HMT Report though to what extent HMT will be willing to recognise third-country transactions remains to be seen.
- **Jurisdictional scope**. As with the EU Report, there are some helpful clarifications relating to extra-territorial impact:
  - **Sell-side obligations:** the New Framework clarifies that the rules only apply to UK entities but that UK investors need to ensure that, where an originator, sponsor or original lender is not established in the United Kingdom, that risk retention requirements, credit-granting and due diligence requirements are complied with.
  - **Sponsor obligations:** the HMT report did not address the mismatch between Article 5 (1)(b) and Article 9 and this has not been addressed in the proposed New Framework.
  - **Buy-side obligations – availability of disclosures:** the UK has adopted a different approach to the EU (which continues to require Article 7 transparency, including for investors in third-country securitisations as discussed above) with the New Framework taking into account recommendations of the HMT Report relating to third country disclosure and provided some clarifications aimed to limit disincentives for UK investors to invest in third-country securitisations. Requirements for verification that information provided in relation to non-UK securitisation is "substantially" the same as under Article 7 of the UKSR is replaced with a requirement for "sufficient" disclosures to assess risk, with access to further information. In terms of what is "sufficient", the rules provide, in relation to Article 5(1)(e), information that must be included as a minimum and without the need for templated information.

The jurisdictional scope of the UKSR and ambiguities as to interpretation of what is "substantially" the same have been problematic for the market. There have been calls for a more principles-based approach or even an equivalence standard to apply; however, the HMT Report was clear that for investor protection the best outcome we could expect was clarification as to what information is required. Uncertainty in this area, and requirements that have not corresponded with those familiar to third-country originators, has often resulted in third country transactions not targeting UK or EU investors or including disclaimers in documentation that disclosure and on-going reporting may be non-compliant and that each relevant investor should make its own decision on whether to invest. Whether the UK approach will facilitate sufficient inroads for investment in third country securitisations remains to be seen but removal of the requirement for the templated information is a welcome development.

- **Buy-side obligations – AIFMs:** Similar to the EU Commission recommendations, due diligence requirements for AIFMs will only apply to UK authorised AIFMs which is a welcome clarification for the market.

What will happen next in the EU?

Prudential treatment

The current prudential treatment of securitisation is believed by the market to be a significant impediment to the development of the securitisation market. Awaited with great anticipation after the EU Report therefore was the Prudential Report which was published on December 12, 2023.

The ESAs recommended some targeted changes but, with the exception of significant risk transfer (**SRT**) transactions, the ESAs believe that the current framework is not a key obstacle to the improvement of the securitisation market. They believe this is, at least in part, due to a combination of factors, not least supply and demand issues and due diligence requirements. They recommended that areas not within scope of the ESAs' mandate for the Prudential Report be investigated including monetary policy, the potential benefit of non-financial corporate activity in the market, the proportionality of current investor protection requirements and the overall "stigma" attached to securitisations.

Whilst encouraging that the ESAs intend to remain focussed on analysing how to address areas that can be improved to facilitate EU securitisation recovery and to review certain aspects of the framework, as with the EU Report, it was disappointing that they didn't take a bolder approach.

The Prudential Report is now with the EU Commission to determine whether to implement any regulatory changes[16].

SRT framework

We also await any proposed developments on SRT.[17] This has been eagerly awaited by the market since the EBA published its report[18] on SRT in securitisation under Articles 244(6) and 245 (6) of CRR in October 2020. Harmonisation and standardisation in this area could have a material impact and is long overdue. The EU Report noted that the EU Commission is currently reviewing the requirements for SRT, including whether to introduce any delegated act.

Future legislation on non-prudential matters

No legislative changes are currently proposed but there are certain areas where the EU Commission has expressed a willingness to consider changes, namely in relation to clarifying (i) the inconsistency between Article 5(1)(e) and Article 7 and (ii) the wording of Article 2(12)(d) as discussed above. Improvements to the regulatory and implementing technical standards for transparency requirements will be considered by ESMA, rather than modifying the Securitisation Regulation in this area at this stage.

Sustainability

The EU Commission agrees with the EBA that there is no need for a separate green securitisation label for the moment. Instead sustainability matters are being addressed as part the EuGB. We note that the same view was shared by HMT.

Final thoughts

It is disappointing that, whilst the EU Commission acknowledged that the Securitisation Regulation has not facilitated the growth in the European market that had been expected, it wanted more time to fully consider what might be needed. We consider that an opportunity has been missed to propose changes now to the Securitisation Regulation, in particular in relation to private securitisations, extra-territoriality and disclosure. The clarity that has been provided in relation to the sell-side obligations and AIFMs is welcome however, although the market would have benefitted from a bolder approach or at least additional guidance.

More developments are in the pipeline; it will be interesting to see to what extent the EU and UK regimes move in parallel or diverge and, if there is further divergence, whether that has a practical impact on these markets.

This article is for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. This article is dated October 3, 2023 and is an update of an article originally published by Hogan Lovells on October 10, 2022. Please contact Hogan Lovells if you require assistance or advice in connection with any of the above.

Contact us:

Hogan Lovells

Atlantic House

Holborn Viaduct,

London

EC1A 2FG

Tel: 020 7296 2000

Web: www.hoganlovells.com

Notes

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52022DC0517&from=EN

[2] This followed the Targeted consultation on the review of the EU securitisation framework. (https://finance.ec.europa.eu/regulation-and-supervision/consultations/2021-eu-securitisation-framework_en)

[3] A separate report on prudential matters under Article 519(a) of the Capital Requirements Regulation (CRR) was published on 9 December 2022.

[4] https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2022/1027593/EBA%20report%20on%20sustainable%20securitisation.pdf

[5] https://www.esma.europa.eu/sites/default/files/library/jc_2021_16_-_esas_opinion_on_jurisdictional_scope_of_application_of_the_securitisation_regulation_003.pdf

[6] https://www.eba.europa.eu/esas-publish-joint-advice-eu-commission-review-securitisation-prudential-framework

[7] EBA Report on developing a framework for sustainable securitisation dated June 2022.(https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2022/1027593/EBA%20report%20on%20sustainable%20securitisation.pdf)

[8] Final Report on Regulatory Technical Standards With regard to the content, methodologies and presentation of disclosures in respect of the sustainability indicators in relation to adverse impacts of the assets financed by the underlying exposures for STS securitisations on the climate and other environmental, social and governance-related adverse impacts pursuant to Article 22(6) and 26d(6) of Regulation (EU) 2017/2402. (https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Draft%20Technical%20Standards/2023/JC%202023%2013/1055704/JC%202023%2013%20-%20Final%20report%20on%20ESG%20disclosure%20for%20STS%20securitisations.pdf)

[9] The ESAs discuss this in the Sustainability RTS and in the ECB and ESAs call for enhanced climate-related disclosure for structured finance products (https://www.eba.europa.eu/ecb-and-esas-call-enhanced-climate-related-disclosure-structured-finance-products)

[10] The ESAs had a narrow interpretation of Article 6, that an EU-based entity should retain the risk.

[11] Article 5(1)(e) requires that investors verify that, "where applicable", Article 7 disclosure and transparency information is satisfactory before investing in a securitisation. This has been subject to different interpretations and raised concerns amongst EU investors that (i) non-EU originators, sponsors and SSPEs had to comply with Article 7 on an extra-territorial basis or (ii) EU investors could be prevented from investing in third-country securitisations.

[12] https://www.afme.eu/Portals/0/globalassets/Securitisation%20Regulation%20-%20Request%20for%20guidance_Article%205%20(1)%20(e).pdf?ver=2022-12-15-100812-347&timestamp=1671098980586

[13] AFME's Article 5 Issues Report Due-diligence requirements for institutional investors under Article 5 SECR of 14 June 2023 (https://www.afme.eu/Portals/0/DispatchFeaturedImages/Article%205%20Issues%20Report%20-%20June%202023-1.pdf)

[14] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1040038/Securitisation_Regulation_Review.pdf

[15] The UKSR is to be replaced as part of HMT's proposals for a smarter regulatory framework for the UK. On 11 July 2023, HMT published a near-final version of The Securitisation Regulations 2023, (the Securitisation SI - https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1168703/Securitisation_Regulations_2023_-_Draft_SI.pdf) together with an explanatory Policy Note (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1169004/Securitisation_Regulations_2023_-_Policy_Note__1.pdf). The Securitisation SI empowers the Financial Conduct Authority (the FCA) and the Prudential Regulation Authority (the PRA) to make certain rules which will be more principles-based and replace some requirements that are currently contained in the UKSR, with rules to be set out in the PRA Rulebook and the FCA Handbook (the Rules, together with the New Framework. The PRA published its proposed Consultation Paper15/23 – Securitisation: General requirements (https://www.bankofengland.co.uk/prudential-regulation/publication/2023/july/securitisation) on 27 July 2023, followed by the PRA's approach to supervision of the banking and insurance sectors on 31 July 2023 (https://www.bankofengland.co.

uk/prudential-regulation/publication/pras-approach-to-supervision-of-the-banking-and-insurance-sectors). The PRA proposes a new Securitisation Part of the PRA Rulebook and changes to SS10/18. The FCA published its proposed FCA Consultation Paper 23/17 (https://www.fca.org.uk/publication/consultation/cp23-17.pdf) on 7 August 2023. The new framework is part of the wide-ranging measures introduced by the Edinburgh Reforms (http://www.gov.uk/government/collections/financial-services-the-edinburgh-reforms) and is part of HMT's plan for "Building a smarter financial services framework for the UK" (https://www.gov.uk/government/publications/building-a-smarter-financial-services-framework-for-the-uk) which will enable the regulators to adapt more swiftly to market needs and adjust Rules where required.

[16] The ESAs will continue to monitor the securitisation market as a whole and raise prudential matters with the Basel Committee of Banking Supervision (BCBS) where relevant. There have also been some welcome developments in trilogue with the Commission on proposals for the capital requirements regulation (CRR3) but these issues will continue to be raised as areas for further debate, including at BCBS level.

[17] The EU Commission is currently considering its powers to recommend delegated legislation pursuant to Articles 244(6) and 245(6) of the CRR to improve the current SRT framework.

[18] https://www.eba.europa.eu/sites/default/documents/files/document_library/News%20and%20Press/Press%20Room/Press%20Releases/2020/EBA%20calls%20on%20the%20EU%20Commission%20to%20harmonise%20practices%20and%20processes%20for%20significant%20risk%20transfer%20assessments%20in%20securitisation/962027/EBA%20Report%20on%20SRT.pdf

Securitisation in Portugal: an introduction to the legal framework

By Pedro Cassiano Santos, Sebastião Nogueira and Henrique Ferreirinha Baptista, VdA

As a dynamic European financial hub, Portugal has crafted a bespoke regulatory environment that caters to investors' needs and safeguards their interests. In this article, we delve into the pillars of Portugal's securitisation framework, highlighting its remarkable features such as bankruptcy remoteness for issuers, stringent insolvency limitations, and the noticeable diversity of asset classes securitised thus far.

Introduction and applicable legal framework

Securitisation saw its first developments in the United States at the beginning of the 1980s and have already been the subject of legislative treatment in most of the member states of the European Union. Its use has been quite successful, and it has quickly become an important factor in the competitiveness of global and modern economies. Our country is no exception to this trend and the first securitisation carried out in Portugal dates back to 1997. At the time no specific regime was applicable to securitisation in Portugal and such transactions were structured by finance lawyers and market players under the general rules set out in the Portuguese Civil Code and the Portuguese Commercial Companies Code.

Since then, the financial and social usefulness of this tool has been increasingly recognsed and its complexity has grown, presenting new challenges and risks for those involved, which the general legislation was not prepared to respond to. This led the Portuguese legislator to enact Decree-Law No. 453/99 of November 5, 1999, which was amended several times and most recently on September 23, 2019 (the "**Securitisation Law**"). The concept of securitisation was thus formally introduced into the Portuguese legal system in 1999, providing economic agents in general, and the financial system in particular, with an important financial tool that is widespread - and frequently used - in other developed economies.


Pedro Cassiano Santos


Sebastião Nogueira


Henrique Ferreirinha Baptista

Pedro Cassiano Santos, Partner
Tel: +(351) 213113479

Sebastião Nogueira, Managing Associate
Tel: +(351) 213113479

Henrique Ferreirinha Baptista, Associate
Tel: (+351) 213113400

As cornerstones regulated under the Securitisation Law we would highlight the following matters:

(a) incorporation of securitisation vehicles;
(b) receivables eligibility criteria for securitisation purposes;
(c) licensing, authorisation and assignment requirements;
(d) notification of borrowers;
(e) servicing of the assigned assets; and
(f) segregation of assets and bankruptcy-remoteness.

Finally, we would also highlight that European regulations are also directly applicable in Portugal, leading to the potential need for Portuguese securitisations to additionally comply with Regulation (EU) 2017/2402, laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation (the "**Securitisation Regulation**") and Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market.

If a transaction meets the definition of securitisation provided under the Securitisation Regulation, certain parties to that transaction will or may have additional regulatory obligations, such as (a) due-diligence requirements for institutional investors, (b) risk retention and (c) transparency requirements for originators, sponsors and securitisation special purpose entities.

It should be noted however that not all Portuguese securitisations fall under the definition of securitisation provided under the Securitisation Regulation.

Securitisation structures in Portugal: the STC

Securitisations under the Securitisation Law may be structured in two different ways, depending on the type of securitisation vehicle to be used.

The transaction may be either structured through a securitisation fund (also known as an FTC) or through a securitisation company (also known as an STC) and only these entities are eligible assignees for the purposes of the Securitisation Law. The incorporation of both these vehicles is subject to prior approval from the Portuguese Securities Market Commission (the "**CMVM**") which also carries out their ongoing supervision.

Given the complexity of fund structure and the alternative offered by the STC, the use of FTCs in Portugal is currently quite low when compared to that of STCs. For this reason, we'll focus on the use of STCs.

STCs are public limited liability companies whose exclusive corporate purpose is to carry out credit or risk securitisation transactions, through their acquisition and the issuance of securitisation notes (debt instruments) for payment of the credits or risks acquired. STCs are multi-securitisation SPVs, operating on a silo-by-silo basis. Each securitisation transaction corresponds to a separate silo, without cross-contamination across silos. When entering into a transaction, the STC will acquire a receivables portfolio and fund it through the issuance of securitisation notes, normally (but not necessarily) tranched in two or more classes. This receivables portfolio will be used to pay the liabilities under the issued securitisation notes, with the notes being repaid by means of cash flows generated by the underlying receivables portfolio.

STCs: bankruptcy remoteness and legal creditor's privilege

The Securitisitation Law provides for several rules that ensure that securitisation transactions structured through an STC benefit from bankruptcy remoteness of the STC and that the proceeds arising from collection of the receivables are exclusively allocated to repayment of transaction creditors and investors. The transaction creditors (including the investors) will have the benefit of the statutory segregation provided for under the Securitisation Law which provides that the assets and liabilities of the STC in respect of each issuance of securitisation notes by it are completely segregated from the other assets and liabilities of the STC. Conversely, the rights of the investors and of any service providers existing specifically in the context of the issuance of the notes, are of limited recourse to the assets collateralising the issuance of such notes, i.e., collections and transaction accounts.

Accordingly, repayment of principal, payment of interest or other amounts in respect of the notes issued by an STC, as well as any fees and expenses owed to the relevant services providers existing specifically in the context of the issuance of such notes, are collateralised by the transaction assets existing at a given moment (e.g., collections and transaction accounts) and forming part of the separate estate connected with the issuance such notes.

The right of recourse of such transaction creditors is therefore limited to the specific transaction assets, which constitute an autonomous and ring-fenced pool of assets, exclusively allocated to the issuance of the notes and which is not, therefore, available to creditors of the STC other than the investors and other services providers. Accordingly, the transaction assets of a given securitisation cannot be used to satisfy any other debts that the STC has or may have in the future in relation to other series of notes or other obligations. This is what is known in Portugal as the "segregation principle".

In addition to the above, and in order to render this segregation principle effective, the investors and the other transaction creditors are further entitled to a legal creditor's privilege (equivalent to a security interest) over all of the transaction assets, including those assets outside of Portugal, such as is usually the case for some transaction accounts. Therefore, the rights of the investors and other transaction creditors, regarding the repayment of principal and interest and other amounts that may be due, will, in respect of the transaction assets, rank senior to the rights of any other third-party creditor of the STC.

Given the limited corporate purpose of the STC, besides shareholders and directors, if remunerated, the only creditors of the STC will be the general providers of corporate and other services required for the carrying out of the STC's activity (which are always limited in type and number), the tax authorities for amounts due in respect of taxes, the investors and creditors of each issue of securitisation notes benefiting from the statutory privilege.

Insolvency limitations

In the event of an insolvency of an assignor or a servicer, the Securitisation Law also contains key provisions which aim to protect the investors' position as set out below.

On one hand, no assignment of credits for securitisation purposes under the Securitisation Law may be challenged for the benefit of the assignor's bankruptcy estate, unless an assignment is concluded in bad faith.

On the other hand, all collections held or received by the servicer will not form a part of the servicer's bankruptcy estate.

Common asset classes in Portugal and underlying benefits of their securitisation

Due to the tailor made and investor-friendly regime referred to above, Portugal's securitisation markets have experienced a dynamic transformation over the past decade, with securitisation emerging as a pivotal instrument in driving economic growth and financial stability. We've been advising on a diverse range of assets being securitised by different originators. These diverse asset classes, including non-performing loans, mortgage-backed loans, tax and social security credits, regulatory credits from the electricity sector's tariff-deficit, highway toll receivables, future receivables, TV broadcasting rights, advertising rights, and sponsorship rights receivables, play a crucial role in the Portuguese financial landscape. Below we list some benefits of these transactions, considering typical asset classes securitised in Portugal:

(g) Non-Performing Loans (NPLs): the securitisation of NPLs has been instrumental in cleaning Portuguese banks' balance sheets, enabling them to allocate resources more efficiently and allocate capital to new lending opportunities. This process has played a crucial role in revitalising the Portuguese banking sector's health.

(h) Mortgage-Backed Loans: securitising mortgage-backed loans has provided Portuguese financial institutions with a means to diversify their portfolios and increase the availability of mortgage financing, stimulating the real estate market and homeownership, which is currently under threat in Portugal.

(i) Tax and Social Security Credits: the securitisation of tax and social security credits offers a reliable source of funding for the Portuguese government while providing investors with a stable and low-risk asset class.

(j) Regulatory Credits from Tariff-Deficit in the Electricity Sector: the electricity sector's regulatory credits are unique to Portugal's market, one of the largest companies in Portugal being the most relevant originator in this respect. Securitising these credits has helped distribute the regulatory burden more evenly among market participants, promoting sustainability and stability in the sector.

(k) Highway Toll Receivables: Securitising highway toll receivables has facilitated infrastructure development in Portugal while offering investors a predictable income stream.

(l) Future Receivables: Future receivables, such as those arising from long-term contracts or subscription-based services, can be securitised to unlock immediate capital and finance expansion projects.

(m) TV Broadcasting Rights Receivables: The securitisation of TV broadcasting rights provides broadcasters with upfront capital, which can be invested in content production and technological advancements.

(n) Advertising Rights and Sponsorship Rights Receivables: some of the most famous media companies and sports organisations in Portugal have been monetising future advertising and sponsorship agreements by securitising these receivables, enhancing their financial flexibility.

Finally, as the sustainable finance trend progresses swiftly, sustainable securitisation is expected to become a trend in Portugal, noting that the first Iberian green RMBS was originated and issued out of Portugal in 2020.

Conclusion

In conclusion, Portugal's securitisation regime stands as a shining example of a tailored and investor-friendly framework. With a well-tested track record in the market, Portuguese legislation offers invaluable benefits such as the robust bankruptcy remoteness of the issuer and stringent insolvency limitations. Furthermore, Portugal's versatility shines through as it has successfully securitised a diverse array of asset classes. This adaptability, coupled with its protective measures, cements Portugal's position as a prime destination for securitisation, providing both security and opportunities for investors.

Contact us:

Vieira de Almeida Advogados

Rua Dom Luís I, 28

1200 151, Lisbon

Portugal

Web: www.vda.pt

European securitisation: Five years of legal and regulatory reform

By Ian Bell, CEO, Prime Collateralised Securities (PCS)

For those unfamiliar with the European Union's legislative cycle, the next Parliamentary elections are set for June 2024. This will be followed by a new Commission, likely around September (subject to the traditional horse-trading). So, the last plenary vote in this European Parliament is scheduled for April meaning any remaining primary legislative texts must be agreed latest in March.

With a heavy load of finance files still to be settled between the Parliament, the Council and the Commission, it would be a great surprise if any unexpected changes relating to securitisation regulation and requiring Parliamentary approval were to emerge before the new term. In other words, this is not a bad time to look back on the achievements or otherwise of this Commission, Parliament and Council when it comes to the legislative and regulatory framework governing securitisation. What was the market hoping for and what did it get?

First, a quick look at the European market in that time. Basically, despite 2023 shaping up to be a fairly good year in terms of market issuance, the publicly placed market has stagnated.[1] In 2019 placed issuance stood at €109bn, in 2022 it stood at €82bn and even with this year's increased volume is unlikely to take us beyond €110bn-€115bn.

This is a far cry from the already low-balled €100bn of additional issuance predicted by the Commission to flow from the 2019 reforms. It is even further from the €450bn-€500bn of issuance that would be needed for the European market to resemble those in Australia or the US (even excluding agency paper).

What was the market hoping for?

Following the coming into force of the Securitisation Regulation in 2019, amendments were made to both the Capital Requirement Regulation (CRR), dealing with bank capital requirements, and Solvency II, dealing with the capital requirements for insurance companies. These were

Ian Bell, CEO
Prime Collateralised Securities (PCS)
Email: ian.bell@pcsmarket.org

designed to reflect the rules imposed on the market and the creation of the STS category. However, the market felt that although European policy makers had done much good work, they had yet to see the reforms through to their logical conclusions.

Basically, the view -to which PCS subscribes- is that the first wave of post GFC securitisation regulations treated all securitisations as an undifferentiated class and calibrated the rules (including capital requirements) on the worst of that class. The second wave, enshrined in the Securitisation Regulation, eliminated entirely some features of the worst (e.g. resecuritisations) and carved out, in the STS rules, a category of high quality securitisations reflecting the features of those European securitisations whose performance during the crisis was stellar.

What we and others believe is missing is the third wave of regulatory change that completes these reforms by, amongst other things, correctly recalibrating the rules to match the extremely high quality of STS securitisations.

What did the market think that third wave would look like?

- A recalibration of the CRR capital requirements especially, but not only, for STS transactions reflecting the drastic reduction of the "agency risks" believed to be embedded in securitisations and used to justify the non-neutrality of securitisation capital requirements. For the cognoscenti, this was the reduction of the infamous *p* factor. A reduction of the floor for senior STS tranches from 10% to 7% was also advocated.

  This issue became more acute when policy makers went ahead with the Basel proposal for an "output floor". This proposal requires banks using their own credit models to calculate risk weighted assets for capital purposes (known as "the internal ratings based approach" or "IRB") additionally to use the usually more punitive "standardised approach". These banks would then be required to compare the output of both calculations and use the *higher* of the IRB number and 72.5% of the standardised approach number. Because of the miscalibration of the standardised approach for securitisation, the application of the output floor (from 2025) was likely to raise the capital requirements substantially for banks using the IRB and wishing to invest is the safest securitisations.

- A revision of the rules for inclusion of STS securitisations in banks' liquidity coverage ratio pools. Currently, banks can only use a very restricted set of STS securitisations as part of the LCR pools, in limited amounts and subject to substantial haircuts. This was the transfer of STS securitisations from LCR category 2.b to 2.a or even category 1.

- A revision of the punitive capital requirements, set out in Solvency II, for insurance companies purchasing securitisations to reflect the much better liquidity and credit performance of actual STS securitisations than that implied in the current legislation. Getting insurance companies back into the investor group is a key landmark on the way to a meaningful European securitisation market.

- An easing of disclosure load mandated by the law and the ESMA templates. This is felt by many to be over-engineered, too prescriptive and allowing too few degrees of latitude to adapt to the individual circumstances of a given transaction. It has also been argued that it often requires information for which professional investors appear to have no need. Another concern on disclosure is that it is not commensurate with other asset-based financing channels such as covered bonds. This creates an uneven playing field promoting regulatory arbitrage.

- Connected with the disclosure issue, a re-examination of the distinction between private and public transactions with a view of not requiring private transactions to produce disclosure that is not sought by the professional investors who finance them. This is particularly true of asset-backed commercial paper where the risk is taken by authorised banks. These are required by the Securitisation Regulation to be provided with information they would not ask for or need if the identical financing was provided in a form other than securitisation. Such requirements are costly in both time and money yet unnecessary in their current form.

- The extension of STS to synthetic securitisations to allow banks to transfer risk off their balance sheet on commercially sensible terms and account for the resulting capital requirements at levels that reflect the actual risks still held by them.

In addition to these points, there was the usual host of technical legal points, especially around retention but also STS and other topics where clarifications or tweaks were requested.

To this, during the term of this Parliament, was added a debate about how securitisation was to fit into the new legislative regime for green bonds. This regime was to be enshrined in the EU Green Bond Standard Regulation ("EU GBS"). The debate, which was fierce both amongst securitisation market participants and policymakers, was whether a green securitisation was to be defined, as for all other bonds, by the use of the proceeds for green purposes or by the greenness of the securitised assets.

Ultimately, most market stakeholders concluded that a proceeds-based approach was preferable and more logical. But this left the task of convincing the policy makers.

What did the market get?

At first glance, one has to admit that the haul of regulatory change was disappointingly slim.

- On CRR calibration, the only change was a very narrow exception reducing the p factor but only for banks calculating the output floor of a senior tranche: welcome, especially for larger banks issuing synthetics for SRT purposes, but not quite the in-depth necessary and hoped for re-calibration.

- On LCR eligibility, nothing.
- On Solvency II, nothing.
- On disclosure, nothing…yet.
- On private vs public, nothing…yet.

- The bright spot was the extension in 2021 of STS to synthetics, a change embraced by the markets where 73 synthetic STS transactions have been executed so far.[2]

- Another success story was with the EU GBS where Parliament and Council did explicitly opt for the "proceeds based" definition for future green securitisations.

- And on disclosure and private vs public, ESMA has been mandated to reopen those files and is currently working on some proposals. These are expected to land before the end of the Parliamentary term, but no promises.

So, at first blush a very meagre scoresheet.

Was it all for nothing?

Despite the few goals that were achieved, it would be wrong to conclude that securitisation has made no progress during these last few years. Those interacting on a frequent basis with policy makers in Brussels and across European capitals have not missed a very clear shift in what one can call the "mood music" around this topic. Five years ago, some were convinced that securitisation was not, by definition, a tool of destruction but few risked saying so in public for fear of a political backlash.

Even those few rarely saw well executed securitisation as more than a "nice to have" aspect of the European capital markets. A useful financing channel with some potential capital management benefits but hardly one that had real potential to transform the architecture of European finance. And, amongst policy makers, some of the most sceptical were to be found in the Parliament.

Today, the landscape feels very changed. During the debates on the reviews of CRR and Solvency II and on the EU GBS, support for securitisation (especially STS) was notable from a wide spectrum of the key parliamentary political families. Recently, the heavy weight Franco/German couple – in the form of their respective ministers of finance – openly called for the return of a safe and strong securitisation market as a key to achieving the capital market union[3].

This took securitisation out of the "nice-to-have adjunct to capital markets" bucket and raised it to the level of strategic initiative. The Commission also appears to be much more willing to push this topic far up the agenda and with less reticence in expressing its support.

There are probably a number of interlocking reasons for this.

- In part, the failure of the securitisation market to revive after the Securitisation Regulation reforms lends credibility to the argument that these reforms still need to be completed.
- The slow progress of the Banking Union and the final implementation from 2025 of the Basel Accords will put pressure on banks' capital. This, in turn, raises difficult questions over the capacity of these same banks to finance not only the economy generally but also the enormously capital-intensive Green Plan. A tool that could allow sensible capital management by banks ***and*** create a workable business model for new non-bank financial institutions would hugely help with this looming bottleneck.
- The equally slow progress of the Capital Markets' Union has hindered the creation of adequate means to channel the deep well of European savings into the European economy and thus provide the needed financial returns to an aging population whilst at the same time financing European needs. Outside securitisation, there are not a lot, if any, potential sources of safe, AAA rated instruments able to generate adequate returns for a risk averse investor population.
- And finally, the continuing stellar performance both in credit and liquidity terms of the European securitisation market, in the years before and in the fifteen years following the GFC, becomes ever more difficult to brush aside.

So where to now?

Despite the few concrete successes in improving the legal and regulatory framework for securitisation, those who see the major role this financial channel could play in transforming for the better European finance should not be downhearted. The battle for the hearts and minds of policy makers has shown much that is positive. But real change still needs to come and right now can only come from the next Parliament and the next Commission.

Also, despite much progress, there remains scepticism in some key constituencies. The European Supervisory Authorities and especially EIOPA looking after Solvency II have shown little enthusiasm for the completion of the reforms already started beyond some positive but small tweaks. Some members states remain to be convinced that securitisation is not at best a technology worthy of great suspicion.

What can we expect? So much will depend on the composition of the new Parliament and the choice of the new Commissioner, not to mention possible changes in the political colour of key European governments in the next few months that it would be foolhardy to hazard a prediction. But nevertheless, securitisation faces the future from a better place than it started five years ago.

Contact us:

Prime Collateralised Securities (PCS)

61 Queen Street,

London EC4R 1EB

UK

tel: +44 20 3866 5000

web: www.pcsmarket.org

Notes

1 We are ignoring the issuance of "retained" transactions that were generated only to serve as collateral for central bank liquidity facilities and never touched a real investor's book. Their inclusion in issuance figures was maybe technically correct but highly misleading to anyone seeking to gauge the health of the securitisation market.

2 As of October 7, 2021

3 See Bruno Lemaire and Christian Lindner's open letter in the Financial Times of September 15, 2023. If this was the most public expression of support yet by the Franco/German couple, it was not by far the only one.

Notes

Notes

Contributors & Partners

Allen & Overy LLP

1221 Avenue Of The Americas,

New York, NY 10020

United States

tel: +1 212 610 6300

web: www.allenovery.com

Asia-Pacific Structured Finance Association (APSA)

37th Floor, One Taikoo Place

979 King's Road, Quarry Bay

Hong Kong

tel: +852 6629 1868

web: www.apsa-asia.com

Association for Financial Markets in Europe (AFME)

39th Floor, 25 Canada Square

London, E14 5LQ

UK

tel: +44 20 3828 2700

web: www.afme.eu

Clifford Chance

10 Upper Bank St,

London, E14 5JJ

UK

tel: +44 20 7006 1000

web: www.cliffordchance.com

DG FISMA (European Commission)

Rue de Spa 2, 1000 Brussels

Belgium

email: FISMA-A1@ec.europa.eu

web: https://ec.europa.eu/info/departments/financial-stability-financial-services-and-capitalmarkets-union_en

GSK Stockmann
44, Avenue John F. Kennedy
L-1855 Luxembourg
tel: +352 2718 02 00
web: www.gsk.de

Hogan Lovells LLP
Atlantic House
Holborn Viaduct,
London, EC1A 2FG
UK
tel: 020 7296 2000
web: www.hoganlovells.com

Information Management Network (IMN)
1120 Avenue of the Americas, 6th Floor
New York, NY 10036
US
tel: +1 212 901 0506
web: www.imn.org/group/structured-finance

Prime Collateralised Securities (PCS)
61 Queen Street,
London EC4R 1EB
UK
tel: +44 20 3866 5000
web: www.pcsmarket.org

Reed Smith LLP
20 Primrose Street,
London EC2A 2RS
UK
tel: +44 20 3116 3000
web: www.reedsmith.com

Structured Finance Association
1776 I Street NW, Suite 501
Washington, DC 20006
US
tel: +1 202 524 6300
web: www.structuredfinance.org

Vieira de Almeida
Rua Dom Luís I, 28
1200 151, Lisbon
Portugal
Tel: +351 21 311 36 01
Web: www.vda.pt

Walder Wyss AG
Seefeldstrasse 123, Postfach
8034 Zurich
Switzerland
tel: +41 58 658 58 58
web: www.walderwyss.com

Wolf Theiss
Schubertring 6 ·
1010 Vienna
Austria
tel:+43 1 51510
web: www.wolftheiss.com