Securitisation of the third kind

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1. Introduction

Nowadays about (I did not count the pages) ninety percent of legislation for supervision of European undertakings on financial markets has European heritage. Practitioners face constraints adapting to the new regulatory system because of the immense amount of new rules, the frequent amendments and because of the methods used by the European legislator to design and implement them. Regulation EU 2017/2402 (Securitisation Regulation)[1] has led to much discussion, in particular in respect of the scope of the expression of 'securitisation'. In this paper I will elaborate why this concept is unjustifiably interpreted so widely and why, in turn, this leads to an unnecessary complicated burden for the undertakings concerned.

2. Background of the Securitisation Regulation

Many comments have been given about the background of the Securitisation Regulation so I will suffice with a few short notes on the issue at hand. Recently, securitisation is recognised again as an important means of financing in Europe. The Securitisation Regulation aims to revitalise the securitisation markets in Europe by stimulating investments in so-called 'Simple, Transparent and Standardised' (hereafter STS) securitisation transactions and by harmonising some legislation for all securitisations. These new STS-securitisations must meet a number of conditions which were first drawn up in the Level 1 text of the Securitisation Regulation[2] and that have entered into force and apply since recently. The specification of the conditions in a Delegated Regulation by the European Commission[3] and in Guidelines by the European Banking Authority (hereafter: EBA)[4] is not ready in time. Therefore there is little certainty as to the matter in which the Securitisation Regulation will be implemented and the system has not made a smooth start. The Securitisation Regulation introduces a few more important provisions besides the ones on STS-securitisations. For example: because banks and insurers are the main investors in (STS-) products, a more attractive regime of prudential supervision has been established. Also 'capital relief[5]' is now available to banks and insurers for STS-securitisations and an additional favourable arrangement has been promised to banks in regards to liquidity requirements that will enter into force in 2020[6].

A risk retention requirement is introduced for all securitisations. This obligation to retain risk has been added to negate the stimulus for original lenders or 'originators' of portfolios that are sold and inserted into the securitisation transaction (and for which the purchase is financed by the issuance of securities) to keep good claims for themselves, whilst bringing the bad[7] claims into the security transaction. The risk-retention

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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, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

2 See articles 20 to 22 Securitisation Regulation for regular securitisation and art. 23 to 26 Securitisation Regulation for Asset Backed Commercial Paper securitisation.

3 To specify the homogenity criteria of art. 20 (8) Securitisation Regulation.

4 E BA has published its final texts on 12 December 2018. See (among others): 'Final Report on Guidelines on the STS criteria for non-ABCP Securitisation', EBA/GL/2018/09 of 12 December 2018.

5 For banks much is this is arranged in the new provisions of the Regulation EU nr. 575/2013 (CRR) which have been implemented as a result of Regulation (EU) 2017/2401, *OCEU* L 347 of 28 December 2017. For insurers much is arranged in Delegated Regulation (EU) 2018/1221 amending Delegated Regulation (EU) 2015/35 in regards to the calculation of regulatory capital requirements for securitisations and simple, transparent and standardized securitisations that are kept on by insurers and reinsurers, *OCEU* L 227 of 10 September 2018.

6 Commission Delegated Regulation (EU) 2018/1620 of 13 July 2018 amending Delegated Regulation (EU) 2015/61 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for credit institutions, *OCEU* L 271 of 30 October 2018.

7 A 'bad' claim would be a loan in which the debtor is overdue with the payments of interest and repayments, or when the collateral has a lower value then when what was promised when the loan was taken out. A good

requirements oblige the original lender (or: originator) to retain 5% of the risk in the credit that is brought into the portfolio that is created for securitisation purposes. Because of this, the original lender has a stake in the portfolio and an interest to contribute good quality loans into the securitisation transaction. In other words, risk retention induces the originators to behave carefully when setting up securitisation transactions. The concept of risk-retention was first established for banks by means of sectoral legislation in 2009[8], in 2011 for AIFM and for UCITS[9] and in 2016 for insurers[10]. The Securitsation Regulation combines them for all parties in a directly binding Regulation with direct effect. The scope of these rules on risk retention and other measures that limit the amount of risk of investing in securitisations has been extended to pension schemes that are regulated by the IORP II-Directive[11].

3. What is securitisation?

There has been much discussion about when one can consider a transaction to qualify as a 'securitisation'. This is an important question since if the transaction cannot be labelled a securitisation, the Securitisation Regulation is not applicable in its entirety. If the transaction is a securitisation, a wide array of provisions and far-reaching compliance obligations apply.

Within securitisations, two categories are distinguished: the so-called 'traditional securitisations' as defined in article 2(9) Securitisation Regulation and the 'synthetic securitisation' defined in article 2(10) of the Regulation. Some question whether there is a third type of transaction that qualifies as a securitisation. In other words: can transactions that are similar to a traditional securitisation or a synthetic securitisation, but which do not fulfil the conditions of either, be labelled as a securitisation and therefore be brought within the scope of article 2(9) or 2(10)? If so, would a transaction like this have to comply with burdensome provisions such as article 6 (risk retention) and article 7 (transparency requirements) that oblige the undertaking to disclose detailed reports? In the discussions on this topic many refer to the definitions of 'securitisation' of article 2(1) and 'securitisation position' of article 2(19) of the Securitisation Regulation.

In instances like this, the uncertainties of the interpretation of European legislation become clear. In the desire of the European legislator to adopt the Securitisation Regulation quickly, the legislator failed to explain the background of the provisions on 'regulated securitisations' clearly. Legal practitioners across Europe are used to a national legislative procedure with extensive comment in explanatory notes. In this document the legislator can, and often does, give clarification in regards to the background and objectives of the proposed legislation. The European legislator does not have a similar system and suffices with a few short remarks in the recitals. But more often than not these recitals are long-winded and politicly desirable texts that give little clarification[12].

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quality loan would be a loan without problems in regards to payments by the debtor or the value of the collateral.

8 Article 122 bis and after of Directive 2009/111/EC, *OJEU* L 302 of 17 November 2009.

9 Article 17 and after of Directive 2011/61/EU, *OJEU* L 174 of 1 July 2011 for AIFM and for UCITS in the same Directive a new provision 50bis was introduced in Directive 2009/65/EG (see article 63 of Directive 2011/61/EU).

10 See article 254 and after of Delegated Regulation (EU) 2015/35, *OJEU* L 12 of 17 January 2015.

11 Directive (EU) 2016/2341, *OJEU* L 354 of 23 December 2016.

12 The critical observer might point me to recital (6) of the Securitisation Regulation in which, among else, is determined that: 'In line with the existing definitions in Union sectoral legislation, it is appropriate to provide definitions of all the key concepts of securitisation. In particular, a clear and encompassing definition of securitisation is needed to capture any transaction or scheme whereby the credit risk associated with an exposure or pool of exposures is tranched. An exposure that creates a direct payment obligation for a transaction or scheme used to finance or operate physical assets should not be considered an exposure to a securitisation, even if the transaction or scheme has payment obligations of different seniority'. This recital is perpendicular to the clear statement in the first consideration on which I based my position. What is wisdom? I believe that the European legislator mistakenly has assumed that the old 'sectoral' legislation contained definitions that described a third kind of securitisations. This would have meant that a special prudential treatment would have applied to the third kind of securitisations (resulting in capital reduction). That was not the case. Traditionally we know only two kinds of securitisations for which capital relief, subject to conditions,

In regards to the issue of the scope of the concept of securitisation, the recitals of the Securitisation Regulation are not clear on whether article 6 and 7 of the Securitisation Regulation will only be applicable to traditional and synthetic securitisations or also to other transaction types with features similar to the two defined transaction types. This is particularly problematic when it concerns traditional securitisations that do not involve the issuance of securities. I will not discuss synthetic securitisations further. Legal practice argues that the following transactions should be considered securitisations in the sense of the Securitisation Regulation.

A financier (not necessarily a bank, insurer, AIFMD, UCITS or pension fund, but also an alternative provider of credit to consumers that has obtained a permit to offer credit to consumers, hereafter: 'Financier') is offering loans to consumers. The funding that is needed to provide these loans is financed with own funds that are in turn supplied by the 100% shareholder of the Financier. After the Financier has created a substantial loanportfolio, he transfers the portfolio to a newly founded 'special purpose vehicle' (SPV). The SPV serves as an intermediate that obtains a private loan from banks and pension to finance the purchase of the credit portfolio by the SPV.

This loan is a 'clubdeal' with no issuance of bonds or other types of securities to the pension funds, banks and insurers. The lenders have an agreement with the SPV which arranges that the interest payments and repayments of credit are financed with the proceeds of the credit portfolio that the SPV holds on behalf of the lenders. In order to obtain a favourable interest rate from the lenders, the parties agree that the principal amount of the loans is lower than the value of the transferred portfolio. A private subordinated loan is provided to the Financier for the difference between the value of the portfolio and the loans obtained by the SPV.

The question is whether the transaction described above can be classified as a securitisation according to the Securitisation Regulation. Legal practice argues that it does because it fits the definition of article 2(1) Securitisation Regulation. I argue that is does not since it does not fit the definition of traditional securitisation of article 2(9) Securitisation Regulation. If the answer to this question is affirmative, the Financier will need to comply as an 'original lender' or an 'originator' with article 6 Securitisation Regulation and he will need to keep a continuous net economic interest of 5% in the securitisation. Moreover the Financier (if he is considered an 'originator') will need to comply with the transparency requirements of article 7 Securitisation Regulation.

4. There is no third kind of securitisation

If one interprets the definitions of the Securitisation Regulation widely, especially 'securitisation' in article 2(1), it is understandable that one would qualify a transaction as described in paragraph 3 as a securitisation transaction and because of that, a subordinated loan of a pension fund, bank or insurer would be a 'securitisation position' as defined in article 2(19)[13]. To clarify this point I will display the definition of 'securitisation' of article 2(1) Securitisation Regulation:

'a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics:
(a) payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures;
(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;
(c) […]'

I left out sub (c) of the provision consciously since it refers to 'specialised lending' transactions; this particularly includes project financing etc. I hope the reader will take it from me that we are not dealing with these kinds of transactions here. Other elements of the definition do need to be addressed. The example I

can be applied. Every other type of transactions that present a likeness to a securitisation, resulted in increased capital requirements in stead of capital reduction.

13 This concept is defined as: 'an exposure to a securitisation', which does not provide much clarity.

have given before is a transaction that transfers credit risk of the portfolio to a SPV. Moreover, we can perceive 'tranching' because a non-subordinated loan is provided by the pension funds, banks and insurers to the SPV whilst the Financier provides a subordinated loan. If we interpret the definition of 'tranching' in article 2(6) Securitisation Regulation in the broadest sense of the word, the elements of the definition of securitisation can be considered fulfilled. And one could also attribute the properties of (a) and (b) of the definition to this transaction.

The example can therefore be considered a 'securitisation' since it fits the definition. But, the transaction does not meet the definition of a traditional securitisation. That can only be the case if it concerns:

'a securitisation involving the transfer of the economic interest in the exposures being securitised through the transfer of ownership of those exposures from the originator to an SSPE or through sub-participation by an SSPE, where the securities issued do not represent payment obligations of the originator.'

It is essential that, and I want to emphasise this, in order to classify a transaction as a 'traditional securitisation', there must be an issuance of securities. In the example of the clubdeal above, there is no issuance of secuities by the SPV, nor by the Financier. The issuance of securities is central to the question whether a transaction is a securitisation or not, or at least whether it is a securitisation in the sense of the Securitisation Regulation. The concept of 'securitisation' itself refers to the process of transformation of an illiquid portfolio of claims to a liquid transferrable security. The concept 'securitisation' itself is deduced from the concept 'securities'. In France this becomes even more clear because they speak of 'titrisation' when they describe securitisations.

First of all, I assign great deal of importance to the recitals of the Securitisation Regulation that clarify the choices of the European legislator. Particularly the first consideration is very clear about the intentions:

Securitisation involves transactions that enable a lender or a creditor – typically a credit institution or a corporation – to refinance a set of loans, exposures or receivables, such as residential loans, auto loans or leases, consumer loans, credit cards or trade receivables, by transforming them into tradable securities. The lender pools and repackages a portfolio of its loans, and organises them into different risk categories for different investors, thus giving investors access to investments in loans and other exposures to which they normally would not have direct access. Returns to investors are generated from the cash flows of the underlying loans.

For me personally this consideration is enough to prove that there is no third kind of securitisation. The consideration evidently and clearly describes the transformative process which leads to the issuance of transferable securities. Unfortunately this has proven insufficient to prevent discussion on the topic. But there is a second argument which determines the distinction between transactions that are regulated by the Securitisation Regulation and those that are not.

I base my additional argument on article 43(1) Securitisation Regulation which states: this Regulation shall apply to securitisations the securities of which are issued on or after 1 January 2019[14]. The legislator clearly means that the transaction must concern securities that are issued for the purpose of a securitisation transaction. The fact that there must be an issuance of securities can also be traced back to other provisions of the Securitisation Regulation. This is the case for article 2(7) (definition asset-backed commercial paper programme, ABCP), article 8(1)(a) and (b) (in respect to the prohibition on resecuritisation), article 22(2) (the verification of the underlying pool of assets), article 26(5) (rules for an ABCP) and the transitory provisions of article 43(2), (3), (5), (6), (7).

The reader might wonder why in spite these arguments some practitioners still assume that a securitisation in the sense of the Securitisation Regulation does not necessarily need to concern the issuance of securities. This is the result of the transitory provision 43(9) of the Securitisation Regulation[15]. In this provision, and only in this provision, there is a mentioning of securitisation 'without the issuance of securities'. The transitory provisions regulate the application of the Securitisation Regulation on securitisation positions that are created on or after 1 January 2019 and is also applicable when no securities are issued. One can only guess

14 Also see consideration (47) of the Securitisation Regulation

15 And also of consideration (6) of the Securitisation Regulation that I mentioned previously.

why this clause was included. There is no relevant legislative history that supports it. However, as I said before, a securitisation must be traditional or synthetic. A synthetic securitisation is possible without the issuance of securities. Therefore it is likely the legislator meant to regulate these in this context. Moreover, the clause cannot be reconciled with the other provisions in the Securitisation Regulation. See above for a list of articles that clearly presume an issuance of securities. In my view, the provision in article 43(9) only exists to bring un-funded synthetic securitisations within the scope of the Securitisation Regulation.

The first consideration of the Securitisation Regulation, the definition of 'traditional securitisation' of article 2(9) that does not leave room for multiple explanations and many other provisions in the Securitisation Regulation – as well as announcements and publications of the Commission about the Securitisation Regulation in the context of the strengthening of the Capital Union[16] – provide enough support for the claim that the Securitisation Regulation only meant to regulate securitisations (insofar it is a securitisation in which a portfolio of loans is transferred, so traditional securitisations) that meet the characteristics of the original form of the transaction that was developed in the 1980s. These were designed by financing of loanportfolio purchases by means of the issuance of securities. It is no longer commonplace in contemporary law that the majority determines how a law is supposed to be interpreted. Nevertheless, I believe that my interpretation does justice to the object of the Securitisation Regulation: the strengthening of the European capital market. Chances are that in a judicial review – by example because of an enforcement issue in which a supervisory authority wants to take action against an entity that violates the obligations in the Regulation by means of an administrative sanction – a teological explanation of the provisions will be upheld, placed in the historical context of securitisation transactions. The way that provisions in the Securitisation Regulation were edited, the legislative history and the context they were written in must lead to the conclusion that the European legislator has not intended to regulate any other kind of securitisation besides traditional and synthetic securitisations. There is no third kind of securitisation!

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[16] See among others: Statement of the European Commission: 'Action plan on building a capital markets union', Brussels, 30 september 2015 COM(2015) 468 final, which contains a passage on page 4: A few examples illustrate the potential benefits. Compared with the US, European SMEs, receive five times less funding *from capital markets*. If our venture capital markets were as deep, more than EUR 90 billion of funds would have been available to finance companies between 2009 and 2014. If EU securitisations could be revived – safely – *to pre-crisis average issuance levels*, banks would be able to provide an additional amount of credit to the private sector of more than EUR 100 billion. And if SME securitisation was re-built to half the crisis peak it could generate EUR 20 billion of additional funding. Investment needs are also great – for example, it is estimated that for the EU's transition to a low carbon economy it will need EUR 200 billion of investment per year (italics by author).