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The International Comparative Legal Guide to:

Securitisation 2017

10th Edition

A practical cross-border insight into securitisation work

Published by Global Legal Group, with contributions from:

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Published by

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London SE1 3PL, UK
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Fax: +44 20 7407 5255
Email: info@glgroup.co.uk
URL: www.glgroup.co.uk

GLG Cover Design

F&F Studio Design

GLG Cover Image Source

iStockphoto

Printed by

Ashford Colour Press Ltd
April 2017

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ISBN 978-1-911367-47-5

ISSN 1745-7661

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Securitisation in Light of the New Regulatory Landscape



Shearman & Sterling LLP

Bjorn Bjerke

Introduction

Securitisations have a long-established history as funding vehicles for comparatively illiquid assets. The ability to acquire a broad range of financial assets and to create tranches with specified seniority, maturity and return characteristics including credit ratings as high as “AAA” means that securitisations can be tailored to the specific needs of various investor classes to provide funding for a broad range of underlying assets. With the introduction of the Basel standards, securitisations came to be increasingly driven by the need to address the Basel capital requirements. As securitisations have adapted to the Basel rules, so too have the Basel rules evolved to address perceived shortcomings and to encourage the perceived benefits of securitisations. The evolution of the Basel III securitisation framework reflects the tension between the desire to address identified risks of securitisations and shortcomings of earlier versions of the Basel regime and the recognised need to help build and support a robust securitisation market. As the impact of the Basel III framework starts to ripple through the financial system and banking institutions are adjusting their activities to the evolving capital and regulatory regime, there are significant consequences for parts of the market where banks can no longer provide sufficient amount of cost effective financing. Securitisations have the ability to bridge that gap but will also be subject to various requirements and restrictions that will have to be successfully navigated. This article will explore whether securitisations will continue to present a viable means for the efficient management of banks’ balance sheets. First, however, the article will analyse key elements of the Basel III regime in general and the securitisation framework specifically.

The Basel Framework Generally

The Basel Committee on Banking Regulations and Supervisory Practices of the Bank for International Settlements, later renamed the Basel Committee on Banking Supervision (the “Basel Committee”), has been establishing internationally coordinated capital frameworks for banks dating back to December 1987 when banking authorities in 12 leading industrial countries agreed on a proposed framework for measuring bank capital on a risk-adjusted basis, which was adopted in July 1988 and today is referred to as Basel I. The Basel I framework was criticised for focusing too narrowly on financial risk metrics while ignoring other risk management processes. Consequently, in January 1999, the Basel Committee proposed a new accord (“Basel II”) which, after various revisions, was completed in June of 2004 and adopted by the European Union in January of 2008 and by the U.S. in 2009. However, the intervening financial crises resulted in a

fundamental review of the Basel capital regime and, as an interim step, the adoption by the Basel Committee of major changes to the market risk capital rules in July 2009 (“Basel 2.5”) that introduced a number of important changes that have been carried forward, including a set of additional capital requirements for securitisations and re-securitisations of banks’ positions. This fundamental review resulted in a framework that was adopted in December 2010 and further revised and refined thereafter for a revised capital regime (“Basel III”) that establishes higher required capital levels and introduces a new global liquidity framework.

Basel III effectively establishes financial coverage ratios that require banks to maintain certain minimum amounts of capital to total risk-weighted assets (“Capital Ratios”), a certain minimum of capital to total assets (“leverage ratio”), and require banks to have high-quality investments and access to stable funding to meet their short-term and long-term funding obligations.

The general construct of the Basel III risk-based capital standards is similar to prior Basel standards, but with more stringent limits and a number of other adjustment reflecting the experiences over the intervening years. In the U.S., the minimum common equity Tier 1 capital (primarily common stock) is 4.5% of total risk-weighted assets; the required ratio of all Tier 1 capital instruments to total risk-weighted assets is 6% and the total Tier 1 and Tier 2 capital (primarily common stock and certain preferred and subordinated debt) to risk-weighted assets is 8%. The risk-weighted capital rules provide detailed provisions for various types of exposures, each being assigned a percentage that will then be multiplied by the capital ratio to determine the amount of capital that effectively will be reserved for that particular exposure. These percentages generally range from 20% to 1,250% (resulting in a deduction against capital ranging from 1.6% to 100% of equity assuming an equity ratio of 8%). Certain off-balance sheet or contingent liabilities have an additional multiplier, referred to as a conversion factor, that further reduces the amount of capital that needs to be held against the exposure.

Additional elements of the risk-based capital rules imposed as part of Basel III include: (i) a capital conservation buffer designed to strengthen banks’ resilience during economic cycles which, when fully phased in, will be 2.50% and will be added to the 4.5% generally applicable minimum amount of common equity Tier 1 capital to total risk-weighted assets. U.S. banking organisations that fail to meet the capital conservation buffer are subject to restrictions on their capital distributions, including certain bonus payments to executives; (ii) a countercyclical buffer ranging from 0 to 2.5% (currently at 0%), which is a macroprudential tool that can be used to increase the capital requirements on internationally active banking organisations when there is an elevated risk of above

normal losses in the future; (iii) capital requirements for certain investments in the equity of funds held in the banking book, which contemplate that such exposures will be deducted from equity or given a risk-weighted capital charge of 1,250% unless the fund can apply a look-through approach to such fund investment; (iv) revised, standardised, approach for measuring counterparty credit risk exposures; (v) revisions to the securitisation framework issued in December 2014 and July 2016 to strengthen the capital standard for securitisation exposures held in the banking book; and (vi) initial and variation margin requirements for non-centrally cleared derivatives.

The risk-based capital regime is based on the common-sense notion that less capital is required to be reserved against low-risk exposures while higher-risk exposures require more capital capable of absorbing losses to be reserved. Basel III also introduced a leverage ratio that imposes a minimum ratio of Tier 1 Capital to total on- and off-balance sheet leverage. Generally the leverage ratio is calculated on the basis of applicable accounting principles for purposes of determining the on-balance sheet exposure, which is further adjusted to add back in certain off-balance sheet exposures (by multiplying such exposures by the applicable credit conversion factor), back out certain collateral and other risk mitigants to arrive at the relevant gross-exposure and make certain additional adjustments for derivatives and assets that have been deducted from capital. The leverage ratio is intended to reduce the overall leverage of a relevant institution, but because that ratio does not adjust for the underlying risk, the leverage ratio creates an incentive to invest in higher-returning, and therefore riskier, assets. In jurisdictions with a high leverage ratio, such as the United States, banking institutions are likely to be constrained by the leverage ratio rather than the capital ratios which will drive certain balance sheet optimising activities that are different from that of banks that are primarily constrained by the risk-based capital ratios and which therefore will have an incentive to optimise their risk-weighted return similar to what was the case under prior iterations of the Basel standard.

The Basel Committee has mandated a minimum leverage ratio of 3%. However, some jurisdictions have imposed higher requirements. For example, the United States has implemented a 4% Tier 1 Capital to total leverage ratio and has in addition imposed a 3% supplemental leverage ratio, effective January 1 2018, for banking organisations that are subject to the Basel III “advanced approaches” (*i.e.* using approved internal models to determine the appropriate weighting of various risk-weighted assets). These are banking entities that, together with their subsidiaries, hold consolidated assets of \$250 billion or more or consolidated on-balance sheet foreign exposures of \$10 billion or more. The United States has also imposed enhanced supplemental leverage ratios applicable to global systemically important bank holding companies (G-SIBs) which, when effective starting 2018, will require an additional 2% to be added to the supplemental leverage ratio (for a supplemental Leverage Ratio of 5% in total) to avoid restrictions on capital distributions and discretionary bonus payments. In addition, in order to be considered “well capitalised” (which brings with it further regulatory benefits without which the banking operations are subject to stricter scrutiny and consent requirements) a U.S. G-SIB bank (as opposed to bank holding company) must add an additional 1% to the Supplemental Leverage Ratio for a total Supplemental Tier 1 Leverage Ratio of 6%.

Basel III also calls for certain liquidity standards to apply to a bank’s net short-term funding liabilities and a bank’s long-term funding needs. The liquidity coverage ratio addresses a bank’s short-term liquidity needs and requires it to hold “High Quality Liquid Assets” sufficient to meet 100% of its net funding needs over a 30-day period. The net stable funding ratio supplements the liquidity coverage

ratio, and seeks to determine the extent to which a firm has long-term funding available to satisfy its long-term funding needs and is intended to discourage excessive “maturity transformation” where banks rely on short-term funding to carry long-term investments. The Basel III rules require banks’ available stable funding sources over a one year look-forward period to meet or exceed such bank’s stable funding needs over such period.

The Basel Securitisation Framework

The Basel securitisation framework applies to securitisation exposures, a term that extends beyond the exposure assumed by asset-backed securities (ABS) investors to also encompass originators, sponsors, liquidity providers and providers of credit enhancement. Basel III continues to include and build on the securitisation framework introduced in earlier Basel standards and continues the fundamental distinction between “traditional” and “synthetic” securitisations introduced under Basel II.¹ These definitions are effects-based and wide enough to capture structures that are not normally considered to be securitisations.

At the heart of both definitions is a requirement that a tranching securitisation exposure is serviced by, and dependent on, the cash flow from underlying exposures and not dependent on the obligation and credit of the originator or sponsor, and that the tranches represent different degrees of credit risk.² The Basel III definition of securitisation is tied to a tranching exposure to a “pool” of underlying exposures. The “pool” requirement is not included in the rules implemented in the U.S. Instead, the U.S. rules provide for various features that must be present for an exposure to fall within the securitisation framework. In addition to tranching, such additional features include that: (i) all or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties other than through the use of credit derivatives or guarantees; (ii) the performance of the securitisation depends on the performance of the underlying exposures; (iii) all or substantially all of the underlying exposures are financial exposures (such as loans, commitments, receivables, credit derivatives, etc.); (iv) the underlying exposures are not owned by an operating company, small business investment company or a firm in which investment would qualify as a community investment; and (v) the transaction is not an investment fund, collective investment fund, employee benefit plan, synthetic exposure to capital to the extent deducted from capital under the capital regime rules or a registered fund under the 1940 Act.³ That the definitions are effects-based is confirmed by the stated need for “supervisors [to] look to the economic substance of a transaction to determine whether it should be subject to the securitisation framework for purposes of determining regulatory capital”.⁴ The U.S. rules similarly specify that the relevant regulatory agency may deem certain, otherwise excluded, transactions to be a traditional securitisation based on its leverage, risk profile or economic substance notwithstanding certain exceptions that otherwise would apply.⁵ The line between covered securitisation exposures and tranching exposures that fall outside the definition is therefore somewhat diffuse and uncertain at the margins.

The definition of synthetic securitisations ties to transfer of a tranching credit risk to an underlying exposure by means of a derivative or guaranty or similar instrument rather than transfer of the ownership to the underlying exposure itself.⁶ The Basel definition further requires the credit risk to tie to “at least two different stratified risk positions or tranches”, whereas under the rules as implemented in the U.S., a synthetic securitisation centres on the transfers of exposures to financial assets and specifically excludes guarantees

of single corporate loans. Synthetic securitisations have the benefit of permitting banks to continue to maintain the ownership of its assets and address any adjustments required for the risk transfers in a separate agreement with the counterparty. A credit default swap (CDS) or a credit-linked note (CLN) or similar unfunded or funded instrument are both examples of instruments that could be used to transfer the risk in a synthetic securitisation under the Basel standards.

The distinction between a senior tranche and a junior tranche is also relevant to the capital treatment of securitisation exposures. The senior tranche benefits from the payment stream from the entire securitised pool ahead of other debt tranches. The Basel III securitisation framework does not require the senior tranche to be the most senior claim in the waterfall (*i.e.* certain expenses and hedging costs may be covered before the senior tranche without thereby jeopardising the beneficial treatment) although if the senior derivative were to be based on the credit performance of the underlying pool rather than being an interest or currency hedge, logic dictates that the derivative would be viewed as a tranche that is senior to other tranches.⁷

Basel III continues the distinction, introduced with Basel 2.5, between regular securitisations and resecuritisations, which are defined as the securitisation of a securitisation exposure.⁸ Examples of resecuritisation exposures given in the U.S. final release include securitisation of residential mortgage-backed securities (RMBS) and is the type of exposure that has been widely blamed for the poor performance of many securitisations in the wake of the financial crisis. Consequently, resecuritisations are subject to much higher capital requirements, and the justification generally centres around the increased complexity, opacity and correlation concerns associated with the underlying exposures. The Basel rules specify that: “An exposure resulting from retransching of a securitisation exposure is not a resecuritisation exposure if the bank is able to demonstrate that the cash flows to and from the bank could be replicated in all circumstances and conditions by an exposure to the securitisation of a pool of assets that contain no securitisation exposures.”⁹ The U.S. rules exclude retransching of a single exposure from the definition of resecuritisation, which is potentially somewhat narrower. As such, retransching potentially remains viable as a means of subsequently adjusting the risk level of an exposure by adding additional subordination to the original tranching financing.

Furthermore, the Basel III securitisation framework continues the imposition of a 1,250% risk-weight if the bank is unable to perform adequate diligence that was introduced in Basel 2.5. The level of diligence required is such that the bank on an ongoing basis has a comprehensive understanding of the risk characteristics of its individual securitisation exposures and the risk characteristics of the pools underlying its securitisation exposures. “Banks must be able to access performance information on the underlying pools on an ongoing basis in a timely manner. Such information may include, as appropriate: exposure type; percentage of loans 30, 60 and 90 days past due; default rates; prepayment rates; loans in foreclosure; property type; occupancy; average credit score or other measures of creditworthiness; average loan-to-value ratio; industry and geographic diversification”; and “for resecuritisations, banks must obtain information on the characteristics and performance of the pools underlying the securitisation tranches.”¹⁰

In order to address the identified shortcomings of earlier Basel securitisation regimes, the Basel III securitisation framework aims to: (1) reduce mechanistic reliance on external ratings; (2) increase

risk-weights for highly-rated securitisation exposures; (3) reduce risk-weights for low-rated senior securitisation exposures; (4) reduce cliff effects; and (5) enhance the framework’s risk sensitivity by applying the following framework and using a more granular calibration.¹¹

The mechanistic reliance on external ratings was addressed by placing the internal ratings-based approach above the external ratings-based approach in the hierarchy used to determine applicable risk-weights and by incorporating other relevant risk drivers, such as maturity and tranche thickness, into the ratings-based approach. In the United States, as a result of the Dodd-Frank Act, reliance on external ratings for relevant purposes is no longer permitted and the external ratings-based approach to determine risk-weights will not be possible.

Despite its shortcomings, the external ratings-based approach has the benefit of providing a simple and intuitive projection of risk-weights across different ratings, maturities and seniorities and will give a rough ballpark for expected risk-weights even where the internal ratings-based approach or the standardised approach otherwise applies to the actual calculation. When comparing the risk-weights under Basel III compared to the Basel II version, it is worth noting how the risk floor for the highest-rated tranches has moved from 7% to 20% and the significant increase in risk-weights assigned to non-senior tranches. The 20% floor is consistent also with the securitisation framework implemented in the U.S.¹²

For securitisations that are not resecuritisations, the Basel III framework mandates the following hierarchy of methods for determining the risk-weight:

- if the bank has the capacity and requisite regulatory approval, it may use an internal ratings-based approach to determine the capital requirement based on the credit risk of the underlying pool of exposures, including expected losses;
- if the internal ratings-based approach cannot be used for a particular securitisation exposure, if permitted within the relevant jurisdiction, the bank may use the external ratings-based approach which has been recalibrated and become more granular compared to the ratings-based risk-weights in the current and past Basel regimes as outlined in Table 2 below;
- if neither of these approaches can be used, the bank would apply the standardised approach which applies a risk-weight based on the underlying capital requirement that would apply under the standardised approach for credit risk, and other risk drivers; and
- if none of these three approaches can be used, then the bank must assign a risk-weight of 1,250%.

For resecuritisation exposures, the only available approach is an adjusted (and more conservative) version of the standardised approach or, if that approach cannot be used, assignment of a risk-weight of 1,250%.

As such, the following risk-weights apply where the external ratings-based model is available:

External Credit Assessment	A-1/P-1	A-2/P-2	A-3/P-3	All other ratings
Risk-Weight	10%	30%	60%	1,250%

Table 1: External Ratings-Based risk-weights under Basel III for short-term ratings.

Rating	Ratings-Based Approach Senior Tranche		Ratings-Based Approach Non-Senior (thin) Tranche		Ratings-Based Approach (Basel II currently in effect, granular pool)	
	Maturity		Maturity		No Maturity Distinct	
	1 year	5 years	1 year	5 years	Sr.	Non-Sr.
AAA	15%	20%	15%	70%	7%	12%
AA+	15%	30%	15%	90%	8%	15%
AA	25%	40%	30%	120%	8%	15%
AA-	30%	50%	40%	140%	8%	15%
A+	40%	50%	60%	160%	10%	18%
A	50%	65%	80%	180%	12%	20%
A-	60%	70%	120%	210%	20%	35%
BBB+	75%	90%	170%	260%	35%	50%
BBB	90%	105%	220%	310%	60%	75%
BBB-	120%	140%	330%	420%	100%	100%
BB+	140%	160%	470%	580%	250%	250%
BB	160%	180%	620%	760%	425%	425%
BB-	200%	225%	750%	860%	650%	650%
B+	250%	280%	900%	950%	1,250%	1,250%
B	310%	340%	1,050%	1,050%	1,250%	1,250%
B-	380%	420%	1,130%	1,130%	1,250%	1,250%
CCC [+/-]	460%	505%	1,250%	1,250%	1,250%	1,250%
Below CCC-	1,250%	1,250%	1,250%	1,250%	1,250%	1,250%

Table 2: External Ratings-Based risk-weights under Basel III compared to the Basel 2.5 framework.

Also new in the Basel III securitisation framework is the concept of “simple, transparent and comparable” securitisations, also referred to as “STC Securitizations”, which are based on criteria jointly developed by the Basel Committee and the International Organization of Securities Commissions (ISOCO) that may assist in the development of such securitisations. Simple, in this context, is intended to refer to homogeneity of underlying assets with simple characteristics and avoiding an overly complex transaction structure. Transparency, goes to disclosure obligations, with the aim of providing investors sufficient information on the underlying assets, transaction structure and parties involved to promote a more comprehensive and thorough understanding of the risks involved and information must be presented in a manner that assists investors in their assessment. Finally, comparability is intended to simplify comparison across securitisation products within an asset class, taking into account differences across jurisdictions.

Implementation of the STC framework is not mandated across Basel III jurisdictions, but incentives for developing the framework come from reduced risk-weight compared to other securitisation exposures.

The STC criteria published by the Basel Committee and ISOCO have been expanded for purposes of Basel III, and are detailed in Annex 2 to the Basel III securitisation framework and provide important detail on the general principles outlined above.

Other Important Rules and Developments

Post crisis regulatory and accounting developments also have potentially significant impact on structuring securitisation

transactions with a goal of optimising balance sheets for Basel III purposes. For example, while U.S. generally accepted accounting principles previously had a construct of a qualifying special purpose entity that automatically would be deconsolidated from the balance sheet of an equity holder, the current accounting principles require compliance with variable interest rules where the transferor retains contractual relationships and other interests and exposures to the securitisation entity to determine if the entity nevertheless is deconsolidated for accounting purposes. This becomes a critical exercise when structuring a securitisation transaction to satisfy the operational criteria for a traditional securitisation outlined below.

The European and U.S. risk retention rules also impose important limitations, especially when viewed in conjunction with the relevant accounting standards. For example, risk retention generally has to be in the form of retention of the most junior security in a securitisation transaction with a fair value equal to at least 5% of the fair value of all securities issued by such entity or in the form of a retention of 5% of each security issued (a vertical slice) or a combination of the two. Given the 1,250% risk-weight assigned to securitisation equity exposures and the ability to treat a vertical slice as a direct exposure to the underlying asset (which avoids the otherwise punitive risk-weight that would apply to a straight summation of the securitisation exposures), vertical risk retention will likely be the viable alternative when securitisations are used for balance sheet optimisation purposes.

The significantly increased regulatory landscape for derivatives and entities such as synthetic securitisations that transfer risk exposures through credit default swaps, coupled with the margin posting and margin use restrictions that are promulgated or in the process of being promulgated, all have a significant impact on the availability, and structuring, of synthetic securitisations.

Balance Sheet Optimisation

The various Basel III requirements and their interplay are complex and differ somewhat between jurisdictions, and financial institutions will consequently have different sensitivities. For example, a bank outside the United States may be subject to improved capital charges if a borrower has a rating whereas in the United States, such ratings will not determine the applicable risk-weight. An institution that is limited by the leverage ratio may determine that it will look to riskier credits to clear its hurdle rates, whereas a firm that is more constrained by its risk-weighted capital requirements may determine that it is economically more feasible to take a higher-rated exposure. The liquidity ratio will impact funding commitments, and effectively increase a bank’s cost of making undrawn revolver commitments, delayed draw term loans and letter of credit commitments. Similarly, the way in which banks will value certain collateral and guarantees will differ based on their other exposures and applicable manner in which they calculate their capital requirements.

Securitisations have since the dawn of Basel I been an important tool to maximise capital relief under the applicable Basel Regime. The evolution of securitisations, especially synthetic securitisations, were influenced by the need of banks to retain the ownership of the underlying exposures while transferring the credit risk and therefore reducing the capital charge. Securitisations are likely to continue to play an important role for banks to satisfy their requirements under Basel III. Securitisations are well suited to create funding for underlying obligations that meet or exceed the duration requirements of such underlying obligations, in line with the net stable funding ratio requirements. A securitisation structure that gives a bank the right to sell in or receive payment for any revolver or delayed

funding obligations within 30 days will provide important relief under the liquidity coverage ratio. As has been demonstrated over the years, securitisations are also well suited to transfer exposures or remove assets from the transferor's balance sheet which should make securitisations suitable for optimising under the risk-weighted capital ratios as well as the leverage ratio.

A bank that is primarily constrained by the leverage ratio will likely look primarily to traditional securitisations for relief. In doing so, the bank must ensure that it complies with the operational criteria for such securitisations. The Basel III operational requirements for traditional securitisations are as follows: (a) transfer of significant credit risk associated with the underlying exposures to third parties; (b) transferor does not maintain effective or indirect control (defined as a right to repurchase to realise their benefits or an obligation to retain the risk) of the transferred exposures; (c) the exposures are legally isolated from the transferor, through true sale or subparticipation, such that they are beyond the reach of transferor's creditors, even in bankruptcy or receivership; (d) the transferee is a special purpose entity (SPE) where the holders of the beneficial interests in that entity have the right to pledge or exchange such interests without restriction; (e) any clean-up calls must meet the following criteria ((x) exercise must be at the banks discretion (cannot be mandatory); (y) cannot be structured to provide credit enhancement or for investors to avoid losses; and (z) can only be exercisable when 10% or less of original underlying portfolio or issued securities remains); (f) the securitisation does not contain provisions that (x) require the originating bank to alter the underlying exposures to enhance credit quality (other than through sale at market prices to third parties), (y) allow the originating bank to increase its retained first-loss position or any credit enhancement provided by it, or (z) increase the yield payable to any party other than the bank in response to a deterioration in the credit quality of the underlying pool; and (g) no termination options or triggers except eligible clean-up calls, termination for specific changes in tax and regulation or permitted early amortisation provisions.

The CRR gives two examples of when significant risk is deemed to have been transferred: (a) where the originator holds a mezzanine position (within the meaning of the CRR) for which the risk-weighted exposure does not exceed 50% of the risk-weighted exposure of all mezzanine transactions; and (b) in a securitisation without a mezzanine tranche, the originator does not hold more than 20% of the 1250% securitisation exposures and such exposures exceed expected loss by a substantial margin.¹³ In other circumstances a substantial risk may be viewed as transferred if the originator can demonstrate in every case that the reduction of own funds is justified by the transfer of credit risk to third parties.¹⁴

A bank that is primarily constrained by the risk-weighted capital ratios may determine that synthetic securitisations provide the optimal intersection between capital relief and control over the underlying asset. However, in order for collateral, guarantees, credit derivatives and other credit risk mitigation techniques for hedging the underlying exposure to be recognised for risk-based capital purposes, the operational criteria must be satisfied. Under the Basel III securitisation framework, these include compliance with generally applicable Basel III requirements relating to counterparty exposures including those relating to what constitutes eligible collateral, provided that securitisation SPEs are not recognised as eligible guarantors for purposes of that framework such that the exposure will have to look to collateral or other guarantors. Banks must transfer significant credit risk associated with the underlying exposures to third parties and the instruments used to transfer credit risk may not contain terms or conditions that limit the amount of credit risk transferred.

A fully paid credit-linked note (CLN) will result in a full transfer of the risk without any further capital charges. On the other hand, a credit default swap that is not fully collateralised or collateralised with assets that are subject to a risk-weighting factor greater than zero will introduce risk either to the counterparty or to the underlying collateral. The single counterparty exposure limits imposed under Dodd Frank and the large exposure regime in the EU also provides limitations on banks' ability to use synthetic instruments to transfer their risk exposures. However, as hinted at above, even if a synthetic securitisation is effective in transferring risk for capital ratio purposes, the underlying exposures will still come into play as part of the leverage ratio calculations and as such may not provide the desired relief in those circumstances. The market for synthetic securitisations is also much smaller and investors are still skeptical to certain synthetic exposures of the type that have given rise to certain conflicts of interest legislation, though not yet any implementing rules, under the Dodd Frank Act. Such securitisations are also viewed as more complex and thus less desirable in the current market, which puts a premium on simplicity. For these reasons, it is likely that traditional securitisations will take on a greater role in balance sheet optimisations, even where the goal is to optimise for risk-weighted capital ratio purposes.

The fact that the Basel III framework hints at use of subparticipations as an acceptable means of transferring underlying exposures to a securitisation SPE subject to receipt of adequate legal comfort that the legal isolation criteria have been satisfied points to the ability for traditional securitisations to afford the core benefit provided by synthetic securitisations in terms of continued control over the underlying asset. For example, in the United States, it is generally recognised that a true participation will provide the required legal isolation for purposes of such participated assets to be viewed as sold for purposes of generally accepted accounting principles. The bank's continued involvement with the underlying participated asset will require careful attention to accounting requirements to obtain off-balance sheet treatment of the securitisation vehicle in order to satisfy the operational criteria for risk transfer through a traditional securitisation. This exercise has become more involved post-crises as a result of accounting changes that, amongst others, eliminated the concept of "qualifying special purpose entities" which essentially afforded off-balance sheet treatment to most, if not all, securitisation special purpose entities, but off-balance sheet treatment is routinely achieved using standard, generally accepted techniques and does not present an insurmountable hurdle.

Conclusion

As the Basel III rules continue to be phased in and the balance sheet pressures of higher risk-weights and the leverage ratio become more significant, we would expect securitisations to receive increased attention to satisfy the growing need for balance sheet optimisation. Securitisations provide capital efficiencies by allowing banks to originate various underlying exposures, transfer the bulk of its exposures to non- (or less) regulated parties wishing to take the credit risk on the underlying exposures and thereby allow banks to continue to service the demand for originating new financing. The consultation issued by the Basel Committee and the International Organisation of Securities Commissioners (IOSCO) to identify criteria for "simple, transparent and comparable securitisations"¹⁵ highlights the need for building sustainable securitisation markets by increasing investor demand. With the added risk-weighted benefits afforded to STC-compliant structures under Basel III, it is likely that the supply for such high quality securitisations will increase which, in turn, would likely contribute significantly toward investor comfort with, and demand for, the asset class, thereby creating a strong force for rebuilding a robust securitisation market.

Endnotes

1. Basel Committee Document: “International Convergence of Capital Measurement and Capital Standards” (June 2006) at 120, available at <http://www.bis.org/publ/bcbs128.pdf>.
2. *Ibid* 2, Chapter IV.
3. Regulatory Capital Rules 78 Fed. Reg. 62018 (62018, 62169) (11 October 2013) at Section __.2.
4. Basel III Document: Revisions to the securitisation framework (11 December 2014 (rev. July 2016)), available at www.bis.org/bcbs/publ/d374.pdf at 8 (BCBS 374).
5. 78 Fed. Reg. at Section __.2.
6. BCBS 374 at 8 & 78 Fed. Reg. at Section __.2.
7. BCBS 374 at 11.
8. *Id.* at 9.
9. *Id.* at 9.
10. *Id.* at 15.
11. See BCBS 374 at 2.
12. 78 Fed. Reg. at 62119.
13. *Id.* at Article 243(2).
14. *Id.* at Article 243(4).
15. Joint Report by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions: “Criteria for identifying simple, transparent and comparable securitisations” (July 2015) available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD494.pdf>.

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