

Update on UK/EU securitisation regulations

December 2024

This note is intended to provide a high-level overview of the securitisation rules in the EU and in the UK. This note represents the views and interpretations of Janus Henderson Investors (JHI), does not constitute legal advice and should not be construed as such. For any legal guidance relating to the eligibility of your investment or your compliance obligations, please consult with a qualified legal professional.

This update provides a summary as to our view of the current state of the securitisation frameworks in the EU and the UK, including the new UK securitisation regulatory framework (UK SRF), which came into effect on 1 November 2024. We have summarised what we see to be the core principles of the securitisation regime in Europe (both EU and the UK), including investor due diligence, issuer transparency requirements, risk retention, and ongoing monitoring. We also discuss the scope of institutional investors that we understand to be affected by these regulations.

Securitisation rules (which exist in the form of the EU Securitisation Regulation (EUSR) and, from 1 November 2024, the UK SRF) had been originally introduced in response to the global financial crisis (GFC) and have always been fairly complex. Post-Brexit, the rules have become even more difficult to navigate due to some divergence between the EU and the UK framework. Post- 1 November 2024, in addition to the divergence between the UK and the EU rules, the UK regime has effectively been split between the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) rulebooks, depending on the type of the entity and activities it undertakes in connection with a securitisation transaction, adding duplication and some further potential for divergence in interpretation, even within the UK. Having said that, as of the date of this update, both the UK and EU frameworks remain substantively aligned. So far, the new UK rules introduce what we see as some helpful relaxation of the rules (especially around investor due diligence) but otherwise, helpfully, remain largely unchanged from their previous version.

The rules in summary

Overall, due to their complexity, certain aspects of the rules remain subject to uncertainty and ambiguity.

Core principles of the securitisation framework:

- **Investor due diligence and issuer transparency requirements** were introduced to ensure all relevant information would be available for an investor to analyse a securitisation in sufficient level of detail to make an informed investment decision.

The EUSR is prescriptive in terms of what information should be made available and dictates in a great level of detail which specific documents and data, and in which form must be made available to. It also requires that investors analyse information provided both prior to investment, and on an ongoing basis. Those requirements must be satisfied not only by EU securitisations but also by the so called "third country" deals where there is no EU issuer and/or originator, to enable an EU institutional investor (see below) to invest in it. This is because the securitisation framework is based on a "dual compliance" principle. Unlike the pre-2019 regime, the obligation to ensure compliance with the applicable securitisation requirements is imposed on both the sell-side and the buy-side parties. Therefore, investors have their own due diligence obligations which they are required to comply with, including the obligation to verify that the applicable transparency and disclosure requirements have been met, regardless of whether the sell-side parties themselves have a statutory obligation to comply.

The UK SRF follows a similar approach to due diligence for institutional investors but has now moved to be more principles-based; in terms of the specific information and its form that investors are required to receive. To that end, the UK SRF has moved to the so called "sufficient information" test which only requires an investor to assess whether sufficient information has been provided to allow independent assessment of the risks, regardless of the format. This means UK institutional investors should now be able to invest in third-country securitisations, which do not produce ongoing reporting in the prescribed templated form – a welcome development in the UK. However, UK investors in our view still need to consider secondary market liquidity implications if data is not being provided in a form that satisfies the EUSR, restricting investment by EU institutional investors.

- **Risk retention** requirements have been introduced by various regulators since the Global Financial Crisis (GFC) to better manage the risks associated to maintain alignment of risk between originators and sponsors of securitisations and investors, with the EU requiring the former to keep 'skin in the game' (a vested interest in its success). While there are technical nuances, in essence the originator of the debt obligation (mortgage, consumer or corporate loan etc.) or sponsor of the securitisation, must retain either:
 - A 5% exposure to that specific transaction for life, either by holding the first loss tranche of not less than 5% of the nominal value of the securitised exposures
 - Or a 5% slice of every tranche sold to investors
 - Alternatively, risk retention can be met by holding a representative (randomly selected) sample of the types of debt obligations being securitised with a nominal value equivalent to 5% of the securitised exposures
 - It can also be met by retaining a first loss exposure outside of the securitisation of not less than 5% of each of the individual securitised exposures
- The entity which holds the 5% retention piece must pass the '**sole purpose test**' which stipulates that it was not created and does not operate solely for the purpose of holding retention pieces for securitisations. The EU and the UK rules on the interpretation of the "sole purpose test" are somewhat similar, but the UK SRF implemented a more principles-based approach to the interpretation of this test. We would again make the point around secondary market liquidity considerations as above.
- **Ongoing monitoring and regular stress testing** of securitisation exposures to monitor performance remains a key element of both UK and EU securitisation regimes (UK SRF has moved to a more principles-based approach whereas the EU remains quite prescriptive). In practice, the principles behind ongoing monitoring and stress testing remain aligned in Europe and the UK. Both require institutional investors to have internal policies and procedures governing the investment process, including procedures for informing senior management and oversight bodies to ensure accountability, governance, documentation and auditability.

Who is in scope?

The EU and UK securitisation frameworks effectively encompass all institutional investors including:

- **Credit institutions** include banks and other financial institutions that accept deposits and provide loans
- **Investment firms** that offer investment services to third parties, such as portfolio management or provision of investment advice
- **Insurance and reinsurance undertakings** that help to manage and mitigate risks for individuals and corporates and within the financial markets
- **Alternative Investment Fund Managers (AIFMs)** include hedge funds, private equity funds, and real estate funds
- **Institutions for Occupational Retirement Provision (IORPs)**, which are pension funds that manage retirement savings and provide pension benefits
- **UCITS management companies** that manage Undertakings for Collective Investment in Transferable Securities (UCITS), which are investment funds regulated at the European level
- **Internally-managed UCITS** that are managed internally rather than by an external management company

In relation to occupational pension schemes, the trustees or managers of such schemes must establish appropriate written procedures relating to investment by such schemes in securitisations, including pre-investment and ongoing due diligence. Based on our understanding, this encompasses instances where securitisation investments are conducted through a segregated account specifically designated in the name of the respective IORP. These due diligence requirements can be delegated, but the trustee or manager retains responsibility unless the delegate is a relevant authorised party (i.e., authorised by the FCA or the PRA). It should be further noted that the new UK SRF has clarified the rules on responsibility for compliance with due diligence obligations (i.e., responsibility for verifying compliance with the UK SRF requirements) where it has been delegated by an asset owner to an asset manager. Where that asset manager is subject to UK SRF, it will be responsible for ensuring compliance with the due diligence rules. However, if the delegated asset manager is not subject to the rules (such as a non-UK AIF), responsibility for compliance with the UK SRF will remain with the asset owner.

The spirit remains clear to us

Despite the complexity, what is clear to us is that the spirit behind the regulations remains. They were implemented as a response to the GFC to address information asymmetry between the sell-side parties (originators and sponsors) and the investors, and to ensure that European institutional investors have sufficient information to make an informed assessment of the risk associated with a securitisation position. They also aim to ensure alignment between originators, sponsors, and investors in securitisation transactions. This is hoped to be achieved by requiring sell-side parties to retain 'skin in the game', as well as putting guardrails around underwriting and origination standards. When considering the detail of the regulations and its interpretation, we think it is prudent to not lose sight of these objectives. At JHI, detailed fundamental due diligence and comprehensive monitoring and stress testing of our exposures has always been at the core of our securitised investment processes. However, the detailed and prescriptive nature of the European securitisation framework, as well as the subsequent divergence between the EU and the UK rules have created a complex regulatory environment for both issuers and investors, with a high barrier to entry for new participants.

Hopefully some simplification is ahead

Fortunately, there appears to be momentum to address at least some of the complexity and overly burdensome aspects of the securitisation requirements, both in the UK where we have seen some positive moves already, and also now in Europe. High profile communications from establishment figures, such as former European Central Bank senior officials, Mario Draghi and Christian Noyer, have highlighted the importance of a better functioning and larger securitisation market, which is seen as essential in supporting growth in Europe. Currently, the European Commission (EC) is seeking feedback on the EU securitisation framework through its broad consultation on most aspects of the securitisation rulebook in the EU. JHI is actively working with industry trade bodies to produce a coordinated response and has represented these bodies in direct communication with regulators. We will continue to update our clients as further developments become available.

Definitions:

Originator: The original lender, or entity that owns the assets to be securitised. This could be a non-financial entity, such as a car company.

Sponsor: A financial institution that purchases the assets from the originator and establishes the securitisation transaction. The sponsor acts as an intermediary between the originator and investors.

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