New Horizons

Legal and structuring developments for new international structured debt transactions

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Introduction

In our New Beginnings publication of November 2009, we set out our views of the changes required to be made to securitisation legal analysis and documentation in order to address some of the issues faced by market participants over the past two years. Since that publication just over six months ago, as we anticipated, a functioning if limited primary market can be said to exist in a number of key consumer asset classes led by RMBS and the debate has moved on considerably in terms of regulation and standardisation of documentation.

In light of these developments, the aim of this publication is to widen the debate further through an exposition of market trends across a range of international jurisdictions which examine the following important themes:

- Regulatory developments covering the impact of aspects of rating agency regulation in the US, a review of the implementation of regulatory changes in key European jurisdictions and a detailed review of the impact of the SEC's proposed changes to Regulation AB on non-US issuance;
- The impact of bank insolvency on structured transactions focussing on UK legal analysis and practical experience from Holland;
- Current challenges for securitisation derivatives ranging from the fallout from the Perpetual litigation to synthetic securitisations; and
- Market updates on key asset classes such as RMBS and CMBS restructurings as well as an article explaining why structured utility bonds have proved to be a major survivor asset class over the last two years.

Being aware that securitisation has been blamed by politicians for much of the financial crisis, it is hardly surprising that the flurry of regulatory initiatives continues apace to address perceived flaws in the pre-crisis securitisation model. Notwithstanding the well-rehearsed critique of some aspects of the pre-crisis securitisation model, there continues to be broad consensus that a functioning securitisation market is a prerequisite to a sustained recovery and availability of credit to the wider economy. Indeed, one consistent theme throughout 2009 and 2010 has been clear support for the re-emergence of a functioning securitisation market by national governments, regulators and supra-national bodies. José Manuel González-Páramo, member of the executive board at the ECB stated in an interview in January 2010:

"Securitisation markets provide an important source of additional funding for banks. They also allow banks to transfer risk, optimise their balance sheet structures and use capital in a potentially more efficient way. If done correctly, under the right market conditions and in compliance with the regulatory framework, the benefits of securitisation can be passed on to borrowers in the form of lower borrowing costs."[1]

The key question for regulators and central banks over the last year or so seems to be focused on what "done correctly" should mean and the plethora of proposed regulation and industry best practice has been focussed on addressing this well-intentioned goal. However, whilst certainly well-intentioned, some of the initiatives may in fact prove to result in unintended consequences. Moreover, despite almost unanimous political espousal of the need for joined up global solutions to a globalised financial market, the reality has in many cases been coloured by local political motivations. What we hope to draw out in this publication are the themes which are common across national boundaries as well as to highlight any inconsistencies of approach and the likely consequences of such disparities. However, many of the regulatory initiatives do seem to be pointing in broadly the same direction so harmonisation of both the substance and spirit of these initiatives will be key.

We hope you find this publication useful and thought-provoking. Should you have any questions, comments or observations, please get in touch with your usual Structured Debt contacts at Clifford Chance or one of the Structured Debt partners listed at page 101.

Kevin Ingram
on behalf of the
International Structured Debt Group
London, June 2010

1 Remarks by José Manuel González-Páramo, a member of the executive board at the ECB in an interview with Credit dated 22 January 2010. *http:www.risk.net/credit/news/1588142/transparency-key-securitisation-revival-ecb-s-gonz-lez-p-ramo*

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1. Investor disclosure

The undisputed mantra in the aftermath of the financial crisis is the promotion of increased disclosure to investors as a key element in tackling the perceived information asymmetry between investors and issuers of asset-backed securities. In the drive to create greater transparency in securitisation markets several initiatives are underway on both sides of the Atlantic to promote such a goal.

In Europe, the European Central Bank has proposed asset-backed securities loan level disclosure for the Eurosystem collateral framework and the Bank of England has launched a consultative paper extending eligible collateral in the Discount Window Facility and information transparency for asset-backed securitisations. In addition, the amendments to Article 122a of the Capital Requirements Directive ("Article 122a") set out increased Pillar 2 due diligence obligations on credit institution investors, creating a further momentum for access to more extensive data.

In the United States, April 2010 saw the U.S. Securities and Exchange Commission publish sweeping proposals to update and expand the regulation of offerings of asset-backed securities and other structure finance transactions in both the public and the private markets.

These parallel initiatives are designed to increase transparency for investors in the securitisation markets and to reduce reliance on rating agencies. In our view, these initiatives may well start to shape investor expectations prior to their formal effectiveness.

The Initiatives

European Central Bank – loan-level information in the Eurosystem Collateral Framework

On 23 December 2009 the European Central Bank (the "ECB") launched a public consultation on loan-by-loan information requirements for asset-backed securities in the Eurosystem collateral framework. In April 2010 the ECB published a summary report of the results of the public consultation, which revealed strong support for the initiative. The ECB initiative centres on the development of a standardised reporting template for disclosure of loan-by-loan data on an ongoing basis for each asset class of securities. The initial template is for RMBS structures, with templates for CMBS, CLOs and other asset classes to follow. The data collected from these standardised templates would then be made available through a subscription-based data portal system.

While there was broad support for the provision of loan-level data, there appears to be significant divergence in the responses the ECB received in respect of a framework for handling the data. Two options had been presented: a single data entry point versus a set of registered portal providers. Whereas certain respondents preferred one option or the other, other respondents proposed alternate hybrid structures, or suggested the collecting and handling of loan-level data through existing market infrastructure including dissemination through regulated stock exchanges.

In view of the positive consultation the Governing Council of the ECB agreed on 22 April 2010 that the study phase of the loan-level initiative could be considered complete and that the Eurosystem could proceed with its preparatory work for the establishment of loan-level information requirements. The preparatory period is expected to last approximately six months. It is envisaged that the Governing Council will assess the results of the preparatory work after summer 2010, after which it would announce the loan-level data requirements.

Bank of England – information transparency for asset-backed securitisations

In March 2010 the Bank of England published a consultative paper seeking views on, among other things, the Bank's initiative to require greater transparency in relation to asset-backed securities and covered bonds as part of the eligibility criteria for instruments accepted in its operations, including the extended-collateral long-term repo operations, the Special Liquidity Scheme (while it is outstanding), and the Discount Window Facility.

The proposed enhanced disclosure requirements would apply to all forms of asset-backed securities accepted by the Bank, from all jurisdictions, with specific requirements applied to each separate asset class. The increased levels of disclosure would be provided publicly to help market-wide transparency rather than being required solely on a bilateral basis to the Bank. Broadly, the Bank is considering the following eligibility criteria for securities accepted in its operations: (1) provision of loan-level data and inclusion of certain stratification tables in investor reports; (2) availability of cash-flow models; (3) availability of legal documentation and summary of structural features; and (4) provision of monthly investor reports (including disclosure of mark-to-market of swaps, account balances and permitted investments).

"While there was broad support for the provision of loan-level data, there appears to be significant divergence in the responses the ECB received in respect of a framework for handling the data"

The deadline for submitting comments on the proposals was 30 April 2010. Clifford Chance was among those submitting a response and was broadly supportive of the initiative. In the light of comments received and following further consultation if necessary, the Bank of England will finalise its proposals for the development of its market operations.

Securities Exchange Commission – regulatory changes to asset-backed securities

On 7 April 2010 the US Securities and Exchange Commission (the "SEC") published sweeping proposals to update and expand the regulation of offerings of asset-backed securities and other structured finance transactions in the US in both the public and the private markets. If adopted in substantially their current form, the proposals in the SEC regulatory statement (the "ABS Release") would have a wide-ranging impact on participants in the asset-backed securities markets in the United States, including on issuers and underwriters outside the United States who would seek to access the deep investor base in the United States for RMBS, Credit Card ABS, ABCP and, potentially, certain covered bonds. Moreover, if the proposals are adopted, the disclosure requirements for public transactions would also become effectively mandatory for private offerings in the United States under Rule 144A and Regulation D of the Securities Act of 1933. The proposals are subject to a 90-day consultation period with a deadline of 2 August 2010.

While certain of the proposed new disclosure requirements foreshadow the proposals of the ECB and the Bank of England, others extend beyond what is currently contemplated in the Eurosystem and the sterling markets. For the first time, disclosure in Rule 144A transactions will effectively be subject to regulation by the SEC, even if the primary market for the securities offered is outside of the United States. Non-US issuers in Rule 144A transactions will be required to undertake to deliver to investors promptly upon request detailed portfolio information, including information about the underlying pool on an asset-by-asset basis. We believe this requirement will mean such non-US issuers will effectively have to comply with such information requirements upfront in order to be able to deal promptly with an investor request.

In addition to the requirements for asset-level data, the proposals in the ABS Release also seek to enhance the pool-level information traditionally provided in most offering documents. Asset-level information will be accompanied by a computer programme (the "waterfall computer programme") that allows investors to perform stress tests on the portfolio cash flows so that they can make their own assessment of the ability of the assets to service the amounts payable on the securities in various scenarios. Like the asset data, this waterfall computer programme would be an integral part of the prospectus so that issuers would be required to provide the waterfall computer programme at the time of filing the preliminary prospectus, with data accurate as of the date of the filing. Similarly, as a prospectus requirement, the waterfall computer programme would be filed with the final prospectus with data accurate as of the date of the filing.

The SEC proposals also seek to enhance static pool disclosure by proposing four new disclosure requirements regarding static pool information: (i) narrative disclosure describing the static pool information presented; (ii) a description of the methodology used in determining or calculating the characteristics presented and a description of any terms or abbreviations used; (iii) a description of how the assets in the static pools shown in the prospectus differ from the pool assets underlying the securities being offered; and (iv) if an issuer does not include static pool information or includes disclosure that is intended to serve as alternative static pool information, an explanation of why they have not included static pool disclosure or why they have provided alternative information.

It is also worth noting that the SEC proposals continue the pull-back from reliance on rating agencies and the hardwiring of ratings into the regulatory framework. For example, the requirement for ratings for a shelf-registration has been removed. At one level it could be observed that the SEC proposals are intended to allow, or even pressure, investors to perform their own analysis in the same way as a rating agency would do.

For more details of the SEC proposal and their potential impact see articles 3 and 4 respectively.

Current European Legislative Framework

Capital Requirements Directive Article 122a

Article 122a is scheduled to be applicable to new securitisations issued on or after 1 January 2011 and after 31 December 2014 to existing securitisations where new underlying exposures are added or substituted after that date. Credit institutions investing in asset-backed securities will, pursuant to Article 122a, have to be able to demonstrate procedures to monitor performance information on the exposures underlying their securitisation positions.

Article 122a imposes punitive capital requirements on an investor who fails by reason of negligence or omission to comply with the due diligence requirements set out in Article 122a(4) and (5). These require investor credit institutions to be able to demonstrate a comprehensive understanding of, and to have formal policies and procedures for analysing and recording: (i) information disclosed by originators as to the interest they are maintain; (ii) the risk characteristics of the securitisation positions and their underlying exposures; (iii) the prior performance of the originator or sponsor in securitising that asset class; (iv) statements by the originators as to their due diligence on the pool and any collateral; (v) methodologies by which the collateral is valued, and the policies of the originator to ensure the independence of the valuer; and (vi) the structural features of the securitisation which could impact the performance of the securitisation position it holds. Investors must also monitor performance of their securitisation positions as a whole, including the diversification, default rates and loan to value ratios of their entire portfolios.

Unlike the SEC proposals, Article 122a does not remove ratings from the framework but reduces their importance by listing the ratings as only one of many factors investors can take into account. This is consistent with our view that US regulators are going further and quicker in removing rating agencies from the regulatory framework whereas European regulators are currently more concerned with reducing over-reliance on ratings.

EU disclosure and transparency requirements – The Directives Triptych

The legal foundation of the EU disclosure and transparency regime applicable to issuers of securities admitted to trading on EU regulated markets is set out over three directives: the "Prospectus Directive", which sets out the content requirements of a prospectus; the "Transparency Directive", which sets out ongoing disclosure obligations on issuers; and the "Market Abuse Directive", which regulates the use and disclosure of inside information and prohibits market manipulation.

"Whatever form the electronic framework for housing the mass volume of data takes, the concept of the prospectus will in our view likely need to expand over time"

The Prospectus Directive requires that a prospectus contain all information which, according to the particular nature of the issuer and the securities, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses and the prospects of the issuer.

The Transparency Directive imposes a requirement for issuers to disclosure regulated information in a manner ensuring fast access to such information on a non-discriminatory basis. "Regulated information" means any information required to be disseminated by the issuer under the Transparency Directive, including any inside information required to be disclosed under Article 6 of the Market Abuse Directive. Pursuant to Article 12(2) of the Transparency Directive Implementing Directive, regulated information must be disseminated to as wide a public as possible and as close to simultaneously as possible.

Article 6(1) of the Market Abuse Directive requires an issuer whose securities are admitted to trading on a regulated market to inform the public as soon as possible of inside information which directly concerns that issuer. "Inside information" is defined as any information of a precise nature which has not been made public, relating directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments and which , if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments. In other words, information a reasonable investor would be likely to use as part of the basis of his or her investment decisions. The Market Abuse Directive further mandates inside information to be made public by the issuer in a manner which enables "fast access and complete, correct and timely assessment of the information" and that any significant changes concerning already publicly disclosed inside information is promptly disclosed through the same channel as the one used for public disclosure of the original information.

Conforming Proposed Initiatives to the Current Regulatory Regime in Europe

The underlying rationale of the initiatives of the Bank of England, ECB and SEC are premised on the fundamental principle that increased transparency and access to information will help re-establish the asset-backed securities markets. Broadly, the initiatives all move in the same direction, which creates the scope for the possibility of a consistent (if not coordinated) approach between these three important market areas. At this stage it is clear that the SEC approach is significantly more prescriptive than the initiatives currently in place in Europe. Market participants and

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observers will be keenly following the development of a prescriptive approach in Europe and its potential interaction with the regulatory reforms across the Atlantic. The devil, as they say, will be in the details: the promotion of one computer data modelling system by the SEC could result in incompatibility with the data portal system promoted by the ECB or the proposed cash flow model disclosure of the Bank of England.

It is also worth mentioning that just as inconsistencies between the initiatives across the Atlantic may develop as these initiatives become implemented, these are not the only contemplated initiatives in their respective jurisdictions. Overlapping regulatory reforms by different agencies and regulatory bodies within these jurisdictions could inadvertently create greater regulatory complexities and hurdles contrary to the stated goals of greater simplicity and transparency. The different agencies and regulatory bodies acknowledge the multiple initiatives and, as reflected in the Bank of England Consultative Paper, there is support for consultation between institutions to ensure, to the extent possible, consistency and complementary requirements.

Data Manipulation and the Prospectus Directive

Proposed amendments to the Prospectus Directive were published in September 2009. Following the publication of the draft report of the Rapporteur to the Committee on Economic and Monetary Affairs of the European Parliament in January 2010 it is the apparent intention to agree and enact an amending Directive some time later this year. One of the more significant changes proposed relate to the proposal to abolish the current 2,500 word limit on the prospectus summary and its replacement with "key information" – namely, sufficient information to enable investors to understand the nature and the risks of the securities and to take investment decisions on an informed basis. What constitutes "key information", however, is still left to be determined. The logical progression would appear to be for "key information" to be informed by the due diligence requirements imposed by Article 122a of the Credit Requirements Directive and, in time, the initiatives being put forward by the ECB in the case of the Eurosystem and the Bank of England in the UK.

These initiatives, and the initial responses from market participants, reveal that investment decisions are made, and pursuant to Article 122a are required to be made, on the basis of processes of data manipulation. The SEC proposals require posting such data in conjunction with the waterfall computer programme on EDGAR, thus forming part of the prospectus requirements. In other words, the data in the waterfall computer programme is at par with the prospectus disclosure. Both the ECB and Bank of England initiatives contemplate the disclosure of asset-level data through the use of a data portal or website framework accessible to investors. The prospectus, however, is fundamentally a legal disclosure document which sets out the information in accordance with the requirements of the Prospectus Directive. What has been apparent for some time, however, is that investor decisions are often made with more emphasis on the data and the manipulation thereof. In our view it would be inappropriate for a prospectus to contain pages of granular, raw asset-level data. The disclosure in the prospectus is, however, likely to expand to contain more narrow categorisations for stratification of data than previously was the case with such categories more properly defined in the context of the securitisation. Unlike the SEC proposals, there is no current discussion at the European regulatory level of the treatment of cash flow model programmes and data portals in the context of prospectus disclosure requirements or their status vis-a-vis the prospectus. Whatever form the electronic framework for housing the mass volume of data takes, the concept of the prospectus will in our view likely need to expand over time beyond an information memorandum and extend to the asset-level, cash flow models and other data provided in these "data portals" (whatever form they take).

Data Protection and Investor Disclosure

Increased disclosure requirements will require a fine balance to be drawn between data protection laws and the requirements imposed on issuers to disclose information under the Transparency Directive and the Market Abuse Directive. Issuers (and any third party administrators) of asset-backed securities will need to take particular care to ensure that the identity of obligors of the underlying assets which are subject to data protection or confidentiality restrictions is fully protected and cannot be inferred from the information contained in the asset data files. Although asset-level reporting may be restricted by data protection laws and banking secrecy laws, having conducted a pan European legal analysis, we do not foresee insurmountable hurdles in this respect.

Disseminating Data under the Transparency and Market Abuse Directives

The Transparency Directive and Market Abuse Directive stipulate requirements for non-discriminatory, wide public disclosure of information. National legislation implementing the Transparency Directive may specify the manner in which such disclosure must be disseminated. For example, in the UK the Disclosure and Transparency Rules of the Financial Services Authority require that all disclosure of such regulated information by issuers whose securities are admitted to trading on a regulated market in, and whose home state is, the UK be made via a FSA approved regulatory information service ("RIS"). Currently these include PRS Newswire and the London Stock Exchange's Regulatory News Service ("RNS"). An information service must satisfy certain criteria in order to be approved by the FSA to qualify as a RIS. These criteria include a demonstrated ability to disclose regulated information to the public/media in a manner ensuring fast access to such information on a non-discriminatory basis. Issuers will need to consider these requirements in choosing how to disseminate asset level information consistent with the requirements of the Directives. The ECB initiative in turn will need to develop the eligibility criteria for any third party data portal providers in light of any limitations or restrictions imposed by national regulatory bodies.

The investor disclosure initiatives uniformly support the disclosure and dissemination of enhanced data to all investors. This is in line with the broad principles of the Market Abuse Directive. However, the proposals in respect of a subscription-based data portal framework for handling data may prove more problematic in some jurisdictions than in others for purposes of the Market Abuse Directive. The issue is whether a subscription-based service falls foul of the definition of "inside information" as "information of a precise nature which is not generally available…" In the UK, the FSA Handbook on the Code of Market Conduct provides guidance on this point, stating that, in the opinion of the UK Financial Services Authority, factors to be taken into account in determining whether or not information is generally available, and are indications that it is (and therefore not inside information) include, among other things, whether the information is otherwise generally available, including through a publication (including if it is only available on payment of a fee). Other national regulators, however, may not take the same view.

Moving forward…

It is clear that the proposals initiated by the ECB, the Bank of England and the US Securities Exchange Commission will go forward, even if not necessarily in their currently proposed form. The feedback on the ECB consultation process was predominantly favourable and while it is expected that similar feedback will be reflected in the current Bank of England consultations, market participants and other observers will undoubtedly be keenly following the comment process on the sweeping SEC proposals.

The due diligence requirements imposed on credit institution investors under Article 122a will institutionalise the momentum for increased investor disclosure. While the due diligence requirements under Article 122a do not go as far as the SEC proposals in their marginalisation of the rating agencies, the push for increased access to data and proposals promoting the disclosure of cash flow models reflect a decisive move in Europe to decrease market reliance on rating agencies in the longer term.

At a minimum, we expect that the proposals will start to establish a new level of "best practice" both in the European and US securitisation markets. As mentioned above, the push for increased investor disclosure is linked to a wide-spread belief that more transparency in the markets through increased investor disclosure will re-open the securitisation markets. Better access to data on the underlying assets may contribute to the re-opening of the markets but we do not believe it will be the overriding contributing factor. The implementation of these proposals, however, should help with the creation and maintenance of a more ordered securitisation market in the longer term, which is a welcome development. Within Europe, pan-European and national regulatory and legislative frameworks will need to be harmonised to decrease administrative burdens of enhanced disclosure on issuers of asset-backed securities. In this respect, hopefully, the broadly consistent "in principle" approach across the various initiatives will be sustained through implementation of more detailed rules and prescriptive approaches. However, we are concerned that the proposed speed of implementation coupled with the political imperative of being seen to be "doing something" to address perceived short comings in the financial markets, will lead to poorer quality regulation and legislation that is not fully thought through or "joined-up". Nevertheless the proposed requirements that effectively all investors in structured finance products receive asset level data accompanied with access to data portal systems or, in the case of the US, a bespoke computer model, has the potential to substantially change how the securitisation markets operate on both sides of the Atlantic.

2. Moving the regulatory goal-posts – how will non-U.S. ABS issuers be affected by the recent SEC reforms?

On 7 April 2010, the U.S. Securities and Exchange Commission (the "SEC") published sweeping proposals to update and expand the regulation of offerings of asset-backed securities and other structured finance transactions in the U.S. for both public and, for the first time, private offerings under Rule 144A and Regulation D of the securities. The proposals, which were made in a 667–page regulatory statement (the "ABS Release"), would involve substantial revisions to Regulation AB ("Regulation AB") under the U.S. Securities Act of 1933, as amended (the "Securities Act"), and other U.S. rules regarding the offering process, disclosure and reporting for asset-backed securities and other structured finance products.

Product areas such as residential mortgage-backed securities ("RMBS"), asset-backed securities supported by credit card receivables ("Cards ABS"), synthetic securities and other structured finance transactions directly or indirectly backed by financial assets, asset-backed commercial paper ("ABCP") and, potentially, certain covered bonds will be impacted by the ABS Release.

Notwithstanding the harmonisation of disclosure levels in the public and private markets, we believe that the proposals will encourage non-U.S. issuers to prefer the private markets in the U.S. over the registered public market.

Reform of the regulation of rating agencies was a focal point in the US even before the financial crisis. The Credit Rating Agency Reform Act 2006 formalised the SEC's role in regulating rating agencies and the SEC has adopted a number of separate rules implementing the "regulation of nationally recognised statistical rating agencies" ("NRSROs") including Rule 17g-5 (discussed briefly below).

Whilst Rule 17g-5 has been implemented, it is very difficult to forecast when the proposals set out in the ABS release will come into effect or what amendments will be made (if any) prior to implementation. If adopted, the provisions of the ABS Release will apply only to asset-backed securities and other structured finance products issued in the U.S. after the date set by the SEC for implementation of the proposals and the SEC has indicated that a transition period will be provided for. However, even prior to adoption, we expect that the proposals will change "best practice" in the U.S. securitisation markets increasing the asset disclosure expected by investors, particularly as the strong position taken by the SEC in a number of areas, such as the provision of loan-level data issue, mirrors some of the recent proposals consulted on by the European Central Bank and the Bank of England.

This memorandum focuses on the impact of the ABS Release on non-U.S. issuers and underwriters of asset-backed securities and other structured finance products sold into the United States in either the public or private markets.

Summary of key changes for the Rule 144A market

- For the first time, disclosure in Rule 144A transactions will be effectively subject to regulation by the SEC, even if the primary market for the securities offered is outside of the United States, as issuers of ABS or other structured finance products will be required to undertake to provide the same level of information as would be required in an SEC-registered transaction promptly upon request by a prospective purchaser.
- Enhanced "loan level" disclosure will be required on each of the underlying pool assets for virtually all U.S. offerings, with specific data fields identified by the SEC for 11 different asset types.
- Periodic data will need to be provided on assets that have been put back to the sponsor or originator for breaches of point-of-sale representations and warranties.
- The loan-level information must be accompanied by a computer programme that allows investors to "stress test" the portfolio cash flows, so that they can make their own assessment of the ability of the assets to service the amounts payable on the securities in various scenarios.
- Information required from issuers of synthetic securities will include details of the difference between cash and underlying credit spreads of the underlying assets.
- Issuers will be required to deliver to the SEC details of each issuance of securities in Rule 144A transactions within 15 days of issuance on a prescribed form.
- The approach to disclosure and the offering process in the public markets, as detailed below, is likely to set the standard for best practice in the Rule 144A market and, possibly, in the international markets.

Key provisions of the ABS Release for non-U.S. Issuers

Historically public transactions registered with the SEC have been the U.S. distribution channel used primarily by non-U.S. issuers for large RMBS and Cards ABS transactions. Whereas offerings using Rule 144A and Regulation D have generally been the distribution channel used by non-U.S. issuers located in emerging markets or for transactions backed by assets that require a more bespoke selling effort, as well as by less-frequent non-U.S. issuers of RMBS and Cards ABS. Accordingly, the impact on both public and private transactions by non-U.S. issuers is discussed below.

New disclosure requirements

Responding to a perceived lack of disclosure to investors in the asset-backed market prior to the credit crisis, the SEC in the ABS Release proposes substantially enhanced disclosure requirements.

Loan-level reporting requirements

Historically, the only statistical data provided to investors in asset-backed securities was at the "pool" level. Under the proposals in the ABS Release, whether or not shelf registration is used, issuers will be required to include detailed loan-level data at the time of issuance, when new loans, cardholder accounts or other assets are added to the pool underlying the securities, and on an on-going basis in periodic reports pursuant to Sections 13 and 15(d) of the Exchange Act.

Issuers of Cards ABS do not have to provide loan-level data. The underlying loan-level data will be provided into combinations of standardised "distributional" groups and data will be provided on a group-level basis.

ABS issuers may struggle at first to meet this new requirement for a variety of reasons, including IT or other technical difficulties in obtaining the information and conflicts with local data protection and bank secrecy laws. The SEC has set out a limited six-day "hardship" exemption but this is aimed at administrative difficulties with making the filing rather than difficulties obtaining the information. A key concern for European issuers is the additional cost of complying with inconsistent regulation by the SEC, the European Central Bank and potentially the Bank of England. A level of international coordination would be desirable for data disclosure purposes.

Waterfall computer programme

The purpose of the requirement to file a computer programme of the contractual cash flow provisions of the offered securities in a prescribed source code with the SEC is to provide users with the

Rule 17g-5

One of the main themes underlying the ABS Release is the perceived failure of the NRSROs most directly involved in the asset-backed securities markets to correctly assess the risk of default in many asset-backed securities and the over-reliance of investors on these rating agencies. Accordingly, the proposals in the ABS Release seek to provide to investors all the data and analytic tools necessary to allow them to make a full evaluation of the risks inherent in any structured product offering, effectively seeking to de-emphasise the role of the NRSROs going forward.

To further the SEC's aim of decreasing investor reliance on issuer-solicited ratings, Rule 17g-5(a)(3) (the "Rule") prohibits NRSROs from issuing or maintaining credit ratings on certain structured finance products unless information that is provided to the NRSRO engaged by the securitisation issuer is also provided to a password protected website which is accessible by other NRSROs. By making this information more widely available, the Rule is designed to promote ratings unsolicited by the issuer on issuance and to facilitate ongoing monitoring by NRSROs which have published such ratings, including ratings paid for by subscribers.

As a result of the Rule, NRSROs have stated that they will require the party appointing them, as a term of engagement of the NRSRO, to agree that the same information which is provided to the engaged NRSRO will be posted to the website accessible to all NRSROs.

Issuer compliance with Rule 17g-5 will necessitate some changes to current transaction practice, for example, legal opinion disclosure language may need to be adapted and there will be some additional prospectus disclosure. However, recently rating agencies have been providing structural queries and comments in comment tables and have requested written responses to those comments. This will facilitate the provision of information to the password protected website. Whilst there will inevitably be some issues to overcome in the first transactions in Europe required to comply with this rule, European issuers will now have the benefit of observing the compliance of US issuers with these requirements. Compliance, therefore, is likely to involve mirroring the developing market standards in the US.

Summary of key changes affecting SEC registered transactions

In addition to the requirements for "loan level" disclosure, a computer programme based on the "waterfall" contained in the transaction documents to be filed with the SEC and data on assets put back to the sponsor or originator as a result of a breach of representation or warranty, the following proposed changes impact the registered market:

- An investment grade credit rating will no longer be a factor in determining eligibility for shelf registration; instead, eligibility for shelf registration will require the following:
  - Retention by the programme's sponsor of a five percent "vertical" slice of each tranche of securities offered to investors or, in the case of Cards ABS, a five percent "seller" interest in the trust assets;
  - Periodic third-party verification of compliance with any asset repurchase provisions for violations of representations in the programme documentation;
  - Certification by the chief executive officer of the depositor at the time of each offering that the asset pool is reasonably expected to generate cash flows sufficient to service the issuer's liabilities; and
  - Periodic reports by the issuer under the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act"), are required for as long as the issued securities are outstanding (rather than only for one year, as presently).
- Each public offering of asset-backed securities under a programme using "shelf" registration will have to be made using a single prospectus containing all material information relating to each individual issuance, other than pricing-dependent information. This prospectus must be provided to investors not less than five business days prior to any sale of the securities. Offerings by master trusts backed by non-revolving assets, such as traditional residential mortgage loans, will *not* be eligible for shelf registration.
- Two new forms of "registration statement" (*i.e.*, the document containing the prospectus and other disclosure required to be publicly filed with the SEC) will be introduced exclusively for asset-backed securities issued in the public markets by both U.S. and non-U.S. issuers, and these forms will contain significantly expanded disclosure requirements. Issuers of structured finance products that do not meet the SEC's definition of "asset-backed security" such as CDOs will still be required to use the traditional forms of registration statement.
- Broker-dealers in public deals will be required to wait for at least 48 hours between the distribution of any prospectus to investors and confirming sales.

ability to build in their own assumptions regarding the future performance and cash flows from the pool assets, including but not limited to, assumptions about future interest rates, default rates, prepayment speeds, loss-given-default rates, and any other assumptions required to be described under Item 1113 of Regulation AB; thereby reducing an investor's dependence on the performance assumptions of the sponsor and/or the rating agencies. The waterfall computer programme must allow the user to integrate those assumptions with the asset data file required to be made available by the issuer at the time of the offering and on a periodic basis thereafter.

Issuers would be required to provide the waterfall computer programme at the time of filing the preliminary prospectus and the final prospectus with data accurate as of the date of the filing.

Non-U.S. issuers, particularly smaller issuers, may be concerned about taking responsibility for the waterfall computer programme, especially where, historically, the transaction "model" may have been prepared by the arranger on behalf of the issuer. A similar requirement is proposed by the Bank of England in its current consultation on its Discount Window Facility. In addition, underwriters of asset-backed securities will need to give consideration to what "due diligence" they need to perform with respect to the accuracy of the waterfall computer programme.

Matters relating to transaction parties

The issuer would be required to disclose the amount, if material, of securitised assets originated or sold by the sponsor or an identified originator that were put back to the sponsor or originator for repurchase as a result of a breach of a point-of-sale representation and warranty on a rolling three-year basis.

The issuer would also be required to disclose whether an independent third party had given an opinion to the trustee confirming that any such assets that had not been repurchased did not in fact violate a representation or warranty and, in certain circumstances, whether the originator has made a representation that there was no fraud in the origination of the assets.

Financial information of the party required to repurchase a pool asset for breach of a representation and warranty pursuant to the transaction agreements will be required, including the interest of that party in the securitisation. Financial information in respect of an originator will also be required.

Prospectus summary requirements

The SEC's proposals will require prospectus summaries to concentrate on the variances that are material to the specific securities described in the prospectus. The ABS Release contains provisions requiring prospectus summaries to include statistical information relating to the types of underwriting or origination programmes, exceptions to the underwriting or origination criteria and, where appropriate, modifications to pool assets after origination.

In our view, it is likely that prospectus summaries will be the part of the prospectus which changes the most as a result of the disclosure reforms proposed in various jurisdictions, as the Bank of England has set out a list of information it proposes to require to be present in the summary section and the European Commission has also set out proposals for the "key information" which must be included in a prospectus that is compliant with the European Prospectus Directive.

"Non-U.S. issuers, particularly smaller issuers, may be concerned about taking responsibility for the waterfall computer programme, especially where, historically, the transaction "model" may have been prepared by the arranger on behalf of the issuer"

Enhanced static pool disclosure

The SEC in the ABS Release has proposed new disclosure requirements regarding static pool information.

Non-U.S. issuers have historically found it difficult to provide static pool data. The harmonisation of disclosure in the public and private markets, if the proposals are adopted, will make it very difficult to avoid preparing, and providing to investors, static pool data so we anticipate that non-U.S. issuers will continue to find the provision of this data challenging.

Pool-level information

In addition to the requirements for loan-level data, the proposals also seek to enhance the pool-level information traditionally provided in most offering documents including:

- disclosure of deviations from the disclosed origination standards and the amount of affected assets.
- disclosure of the verification undertaken by the originator of information used in the solicitation, credit-granting or underwriting of the pool assets.
- disclosure of the provisions in the transaction agreements governing modification of the assets.

Other disclosure requirements that rely on credit ratings

The ABS Release would eliminate certain existing exceptions to disclosure rules, which are based on investment grade ratings.

New registration procedures and forms for Asset-Backed Securities

New forms SF-1 and SF-3

The ABS Release proposes two new forms of registration statement, to be used by issuers of asset-backed securities: Form SF-1 for stand-alone transactions and Form SF-3 for shelf programmes.

New shelf eligibility criteria

Currently, the eligibility of asset-backed securities programmes for shelf registration is based in part on whether the securities to be issued would receive an investment grade rating from an NRSRO. Under the proposals in the ABS Release, the ratings-based eligibility criterion will be eliminated and replaced by the following four new criteria:

- "Skin-in-the-Game": The sponsor will be required to retain five percent of the risk of the securitisation on an ongoing basis, net of the sponsor's hedging.

The impact of this requirement on non-U.S. issuers will turn on where the issuer is based and how their home jurisdiction capital and asset-transfer rules are being applied. We would anticipate that, in the UK and in many other jurisdictions, Cards ABS would not be significantly affected because this asset class is issued primarily through master trusts that generally have seller interests at or above five percent. This standard will not be relevant to many non-U.S. issuers of

traditional RMBS since non-revolving assets such as mortgages would not be permitted to use the shelf registration channel under the proposals.

- Originator buy-back compliance opinion: The party required to repurchase pool assets for breach of representations and warranties will also be required to furnish to investors, at least quarterly, an opinion of an independent third-party as to whether the obligated party acted consistently with the terms of the relevant transaction documents, with respect to any loans that the issuer or the trustee put back to the relevant party for violation of representations and warranties and which were not repurchased or replaced by the obligated party.

Implementation of this requirement will involve additional administration and expense. It is also not clear who will perform the verification role as the ABS Release states that audit firms in the U.S. have already indicated that this sort of opinion would not be within the scope of their professional responsibilities. Further, because there are likely to be relatively few non-U.S. issuers using shelf registration, there may be few service providers focusing on helping issuers outside of the U.S. meet this requirement.

- CEO certification: The chief executive officer of the depositor will be required to file a certification at the time of each issuance utilising a shelf registration statement that the assets in the pool have characteristics that provide a reasonable basis to believe that they will produce, taking into account internal credit enhancements, cash flows to service any payments due and payable on the securities as described in the prospectus.

This requirement is similar to the requirement in the European Prospectus Directive which requires issuers of asset-backed securities to make a statement in the prospectus that the assets backing the offered securities "have characteristics that demonstrate the capacity to produce funds to service any payments on the notes issued".

- Exchange Act peporting: The proposals would also require the issuer to undertake to file Exchange Act reports so long as non-affiliates of the depositor hold any securities that were sold in registered transactions backed by the same pool of assets.

This element of the proposal would require non-U.S. issuers to prepare servicer assessments and obtain auditor attestations under Item 1122 of Regulation AB for the life of the transaction. Preparation of these assessments and obtaining the attestations has proved very time-consuming for non-U.S. issuers, and this requirement may further discourage eligible non-U.S. issuers from utilising shelf registration unless the benefits of shelf registration can be clearly shown to outweigh the challenges of being subject to Item 1122 for the life of the programme.

Shelf offerings - formal requirements

Under proposed new rules the issuer would be required to file a preliminary prospectus that contains all transaction-specific information about the proposed offering except very limited pricing information, such as the offering price/coupon and underwriting discount, at least five business days in advance of the first sale of securities in the offering, This five-day period is intended by the SEC to give investors sufficient time to analyse the transaction and loan-level data and run their own scenario analysis with the waterfall computer programme.

As a consequence, the proposals would result in each they offering being made on the basis of a single prospectus, rather than the existing base-and-supplement format.

Non-U.S. issuers will need to focus on the implications of being required to use a single prospectus in the U.S., rather than a base prospectus and supplement and/or final terms document. If investors become accustomed to receiving a single disclosure document, we may see more non-U.S. issuers voluntarily preparing supplemental prospectuses that are effectively stand-alone for each offering.

Definition of "Asset-Backed Security"

The exception to the definition of an "asset-backed security" in Regulation AB that allowed issuers to use shelf registration for transactions with master trust structures, prefunding periods and revolving periods to allow for changeable asset pools will be amended to prevent master trust issuers from using non-revolving assets (*e.g.*, mortgages). While "standalone" SEC registration would still be theoretically possible, issuers in this situation would need to determine how they would comply with the broader requirements of Form S-1, or obtain exemptions from these requirements.

Changes will also be made to the permissible duration of the revolving period of non-revolving assets and the amount of permitted prefunding.

Excluding non-revolving assets from master trusts in the definition of "asset-backed security" will make accessing the public markets in the U.S. much more difficult for non-U.S. sponsors of residential mortgage master trusts by eliminating the possibility of using the shelf registration channel and forcing these issuers to use "old" Form S-1, which was not intended for issuers of asset-backed securities. Non-U.S. issuers of Cards ABS will not be affected by these changes.

"Even if offerings of commercial paper are not strictly covered by the ABS Release, the enhanced disclosure regime for Rule 144A and Regulation D offerings may effect a change in "best practice" for the level of disclosure in programme documentation for ABCP issuers"

It is not yet clear how the SEC will treat covered bonds for purposes of this definition. The term "covered bond" does not appear in the ABS Release. While most observers are hopeful that the SEC will recognise covered bonds as something other than "asset-backed securities" (or other "structured finance products"), and thus outside the scope of the proposals contained in the ABS Release, this is not clear, and the SEC's final view may turn on the structure of the covered bond programme and the way in which the covered bonds are being marketed to investors.

Exchange Act reporting

The SEC has expressed concern about the quality of on-going reporting to investors in public transactions and proposes several important changes aimed at ensuring investors are made aware of any material change (i) in the asset pool at issuance to the pool data disclosed in the prospectus and (ii) in the sponsor's interest in the offered securities.

The exception for ABS transactions from the requirement that broker-dealers must deliver a preliminary prospectus at least 48 hours before confirming any sale of the relevant securities will be eliminated for all offerings of asset-backed securities, including those involving master trusts.

Key changes for privately-issued structured finance products

The changes affecting the Rule 144A market are summarised in the text box on page 8. This section discusses the impact of the proposed changes in more detail. Many of the changes apply equally to offerings under Regulation D. However, the ABS Release seems to distinguish between Rule 144A offerings and Regulation D offerings, in terms of required on-going disclosure (with specific requirements for on-going disclosure only applicable to Rule 144A offerings). Therefore, non-U.S. issuers may want to put greater focus on the requirements of Regulation D to conduct private offerings in the United States. Although issuers of Regulation D offerings will have to provide similar information that required to be provided for Rule 144A.

The ABS Release would introduce a definition of "structured finance products" to which the new proposals will apply. In addition to traditional "asset-backed securities", other products including synthetic asset-backed securities and fixed-income or other securities collateralised by any pool of self-liquidating financial assets, such as loans, leases, mortgages and receivables will be caught. This change evidences a clear intention on the part of the SEC to close what it perceives as a disclosure "loophole" in their disclosure regulation.

If the notice which must be filed with the SEC within 15 calendar days after the first sale of securities in the offering, has not been filed, then Rule 144A will not be available for subsequent resales.

On their face, the proposals in the ABS Release apply to offerings of ABCP. Most ABCP sold in the United States is offered in private placements with very little disclosure on underlying pool assets or other matters covered by Regulation AB. However, unlike almost all other types of asset-backed securities, ABCP either is, or may readily be, sold pursuant to the Section 4(2) exemption (which is not covered by the proposals in the ABS Release, as noted above). Accordingly, unless the proposals in the ABS Release are revised to address this point, it is possible that issuances of ABCP will not fall into the disclosure requirements in the proposals.

Even if offerings of commercial paper are not strictly covered by the ABS Release, the enhanced disclosure regime for Rule 144A and Regulation D offerings may effect a change in "best practice" for the level of disclosure in programme documentation for ABCP issuers.

The ABS Release can be found at: http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

Conclusion

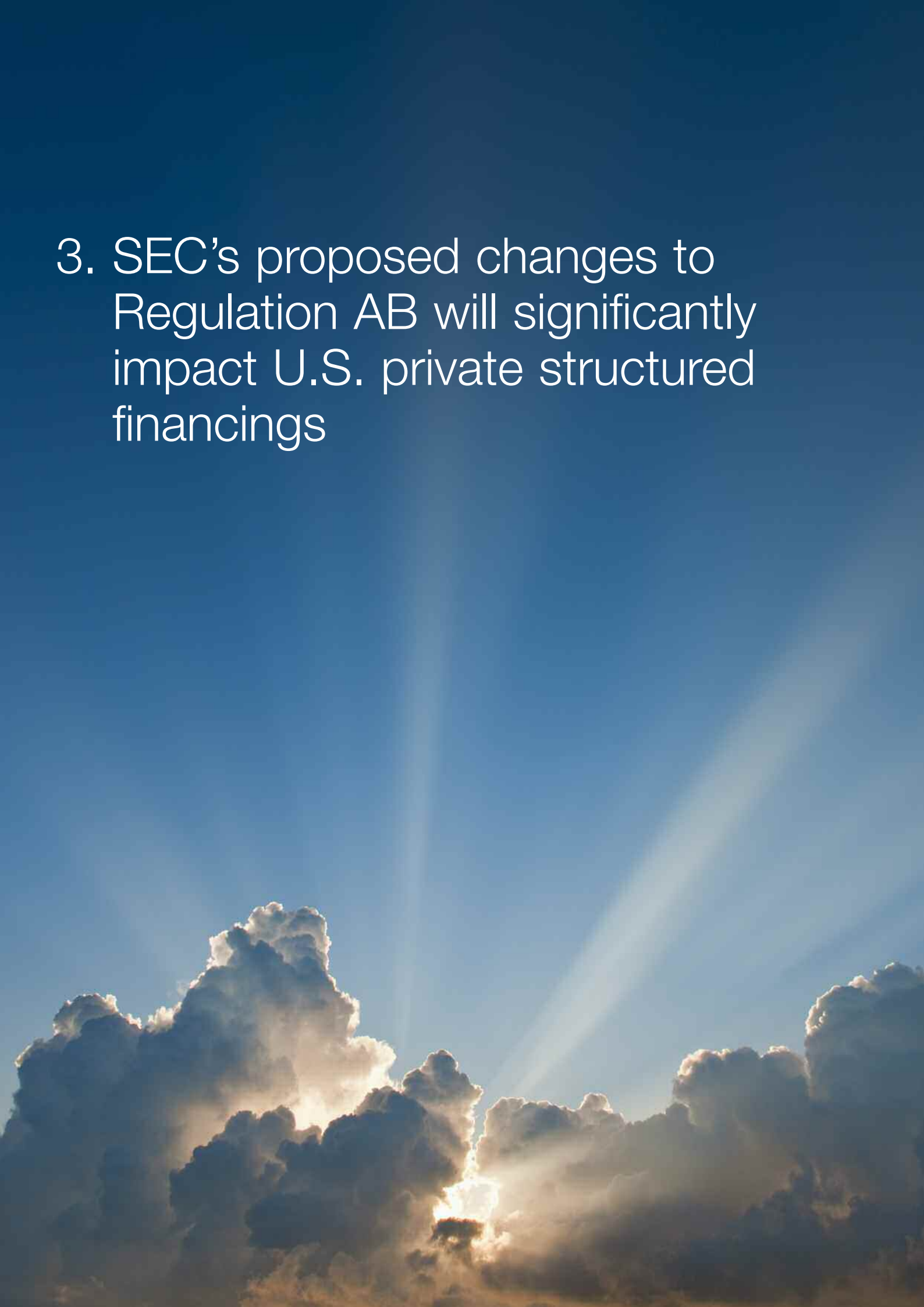
From its broad scope and innovative provisions, the ABS Release represents the most significant governmental initiative in the U.S. to date in the area of regulation of the securitisation markets. The requirement that effectively all investors in structured finance products receive loan-level data accompanied by a bespoke computer model has the potential to revolutionise the securitisation markets in the U.S. and around the world. In addition, by harmonising disclosure in the public and private markets, the SEC sends a strong signal that they expect a greater degree of integrity and "best practice" in the offering and sale of asset-backed securities.

The proposals in the ABS Release have the potential to benefit non-U.S. issuers of ABS and other structured products if they increase investor confidence resulting in the restoration of a vibrant market for these products in the U.S.

At the same time, these potential benefits will come with a not insignificant cost as non-U.S. issuers will seek to adapt to the new requirements and harmonise them with other regulatory initiatives to which they may also be subject in their home markets. In addition, non-U.S. issuers are also currently grappling with the implications of the SEC's separate Rule 17g-5, effective 2 December 2010 (following the recently granted temporary exemption), which regulates conflicts of interest at NRSROs but which places significant burdens on arrangers of asset-backed securities offerings where there is a rating from at least one NRSRO which is paid for by the arranger.

Market participants and other observers will be keenly following the comment process on the ABS Release with the SEC over the next several months for signs of the level of acceptance of these proposals and the chance that they will either be adopted largely in their current form or, alternatively, substantially revised prior to adoption. The degree of take-up of the proposals in the U.S. may also signal whether the ideas proposed by the SEC in the ABS Release wind up setting global standards for the industry.

3. SEC's proposed changes to Regulation AB will significantly impact U.S. private structured financings



On 7 April 2010, the U.S. Securities and Exchange Commission (the "SEC") published sweeping proposals to update and expand the regulation of offerings of asset-backed securities in the United States in both the public and, for the first time, the private markets. The proposals (Release Nos. 33-9117; 34-61858; File No. S7-08-10, the "ABS Release") would involve substantial revisions to Regulation AB ("Regulation AB") under the U.S. Securities Act of 1933, as amended (the "Securities Act"), and other U.S. rules and regulations regarding the offering process, disclosure and ongoing reporting for asset-backed securities ("ABS") and other structured finance products.

If adopted in substantially its current form, the ABS Release would have a wide-ranging impact on participants in the asset-backed securities markets in the United States. One of the principal aspects of the ABS Release is that the SEC proposes to require, for the first time in connection with registered ABS offerings, disclosure of asset-level data for each asset comprising the pool of assets in an ABS, in addition to the pool-level data already required by Regulation AB in its current form. The SEC also proposes to refine existing, and require additional, pool-level data disclosure obligations in connection with registered ABS offerings, in order to enhance the information available to analyse a pool.

With respect to the private ABS market, in the ABS Release the SEC stated that, in its view, investors in many cases did not have the information necessary to understand and properly analyse structured products, such as collateralised debt obligations ("CDOs"), that were sold in transactions in reliance on exemptions from SEC registration. As a result, to address these and other concerns, the SEC is proposing significant revisions to the safe harbours available for resales under Rule 144A ("Rule 144A") under the Securities Act and for exempt offerings under Rule 506 ("Rule 506") of Regulation D under the Securities Act, in order to require specific disclosures in private offerings of structured finance products, as well as additional public information about such private offerings.

"Issuers of asset-backed securities or other structured finance products in most U.S. private transactions…will be required to undertake to provide…the same level of information as would be required in an SEC-registered transaction"

The proposals were published in the U.S. Federal Register on 3 May 2010 (available at http://edocket.access.gpo.gov/2010/pdf/2010-8282.pdf) and are subject to a 90-day public comment period, scheduled to expire on 2 August 2010, during which industry participants may submit comments to the SEC. A substantial volume of comments is likely. Following the public comment period, the SEC may revise the proposals in response to the comments received. The SEC may choose to adopt some or all of the proposals contained in the ABS Release. Alternatively, the SEC may choose to re-propose portions of the proposals if it feels that there are sufficiently meritorious objections from commentators to portions of the original proposal to warrant re-consideration.

At this time, it is difficult to forecast whether or when some or all of the proposals will come into effect. If adopted, the provisions of the ABS Release will formally apply only to asset-backed securities and other structured finance products offered or sold in the U.S. after the effective date set by the SEC for implementation of the proposals. However, we expect that prior to adoption, the proposals will prompt the establishment of various new "best practices" in the securitisation markets in the U.S. and possibly elsewhere. Further, the various proposals may start to shape investor expectations well before any formal effectiveness.

This memorandum focuses on the potential impact of the current proposals on asset-backed securities and other structured finance products offered or sold in the United States under the private offering exemptions most commonly used for such products – Rule 144A and Rule 506.[1] We identify questions that have emerged as a result of the ABS Release and suggest certain

[1] References herein to "exempt private offerings" refer only to offerings conducted in reliance on the safe harbours available under Rule 144A and Rule 506, which are the most common offering exemptions used for ABS offerings in the private markets and which are directly affected by and addressed in the ABS Release.

potential best practices that may (or should) develop among participants in the private ABS market in light of the SEC's expressed views and the possibilities of passage of the various proposals within the ABS Release.

Highlights of New Disclosure Requirements Affecting Non-Public Offerings

The ABS Release contains a number of proposed regulatory changes designed to increase transparency for investors in the U.S. securitisation markets and reduce, and potentially even eliminate, reliance on nationally recognised statistical rating agencies ("NRSROs"). However, the ABS Release would also significantly expand the obligations of issuers and distributors of asset-backed securities. Highlights of the proposals contained in the ABS Release that impact (or will likely impact) the private asset-backed securities market include the following:

- Issuers of asset-backed securities or other structured finance products in most U.S. private transactions (including foreign issuers conducting a Rule 144A offering alongside a separate non-U.S. offering) will be required to undertake to provide, promptly upon request by any prospective purchaser of the securities, the same level of information as would be required in an SEC-registered transaction. In addition, for Rule 144A offerings, the issuer will be required to file a notification of the issuance of structured finance products with the SEC, setting out specified information about the offered securities and the underlying assets, within 15 days after the first sale of securities in the offering. This is similar to the filing that is currently required for offerings relying upon Rule 506 (which would also be amended to apply to structured finance products).
  - Significantly enhanced "loan-level" disclosure will be required on each of the underlying pool assets securing a structured finance product, with specific data fields identified by the SEC for 11 different asset types (although use of grouped data would be permitted for credit card ABS).
  - The required loan-level data will be required to be filed with the SEC in computer-readable form, together with a computer programme based on the "waterfall" contained in the transaction documents that permits an investor to run its own analysis of the assets and the cash flows (the "waterfall computer programme").
  - An issuer will be required to provide historical data with respect to assets that have been "put back" to the sponsor or originator for breaches of point-of-sale representations and warranties.
- The possibility that new requirements proposed in the ABS Release could lead to parallel adoption in certain private ABS markets of public-market procedures, including (i) the use of a single prospectus containing all material information (other than pricing-dependent information) similar to the single-prospectus requirement for shelf offerings (thus eliminating the option of public ABS issuers to use a base, or programme, prospectus and a transaction-specific prospectus supplement for each individual issuance), and (ii) the delivery to investors of a disclosure document at least five business days prior to any sale of an asset-backed security.

New Conditions for Offerings Relying on Rule 144A and Rule 506

The ABS Release, if adopted, would for the first time require that an issuer make available disclosure in the private Rule 144A and Rule 506 markets that is consistent with that required in the U.S. public markets, effectively eliminating the flexibility of transaction parties to independently determine appropriate disclosure based upon what information may or may not be material in the context of a particular transaction. This aspect of the proposal represents a major change from prior practice and reflects a clear intention on the part of the SEC to close what it perceives as a gap in existing disclosure regulation.

Specifically, the SEC is proposing to make the availability of the safe harbours provided by Rule 144A and Rule 506 conditional on a requirement that, if the security offered or sold is a "structured finance product" within the meaning of the ABS Release, the underlying transaction agreements would have to grant any securities purchaser the right to obtain from the issuer promptly, upon request by the purchaser, such information as would be required if the offering were registered on Form S-1 or new Form SF-1 (for non-shelf offerings of ABS), as applicable, under the Securities Act. In addition, the issuer must represent in that transaction agreement that it will provide such information upon request. An issuer's failure to actually provide the required information would give rise to potential breach-of-contract claims, as well as the potential for SEC enforcement

action against the issuer pursuant to proposed Rule 192, but would not, in either case, retroactively disqualify the issuer's compliance with the applicable safe harbour.

The ABS Release would introduce a definition of "structured finance product" which would include, in addition to traditional "asset-backed securities" (as defined under Item 1101(c) of current Regulation AB), synthetic asset-backed securities and any "fixed-income or other security collateralized by any pool of self-liquidating financial assets, such as loans, leases, mortgages, and secured or unsecured receivables that entitles its holder to receive payments that depend on the cash flow from the assets." This includes "a collateralized mortgage obligation, a collateralized debt obligation, a collateralized bond obligation, a collateralized debt obligation of asset-backed securities, a collateralized debt obligation of collateralized debt obligations," or a security that at issuance is "commonly known as an asset-backed security or a structured finance product." This broad definition is designed at least to encompass certain managed ABS, and, since there is no requirement of having a "discrete pool of assets," would also generally encompass all managed structure finance products.

Effect on private market: *In light of the broad definition of "structured finance product" (which the ABS Release specifically states encompasses managed CDOs), sponsors and managers of private managed funds should begin to consider what are the distinguishing features of those funds that place them outside the scope of the definition of "structured finance products." Depending on the structure of the particular private managed fund, inclusion under the rules may hinge on narrow distinctions (such as the meaning of the word "collateralized" within the definition of "structured finance product").*

With respect to Rule 144A, the scope of the information that could be requested also includes ongoing information regarding the securities that would be required by Section 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), if the issuer were required to file reports under that section, and the right to obtain the specified information would extend to any initial purchaser, any security holder or any prospective purchaser designated by a security holder.

Effect on private market: *Under Exchange Act Section 15(d), for an issuer that does not otherwise have a class of securities registered under the Exchange Act, the duty to file ongoing reports is automatically suspended after the first year if the securities of each class to which the registration statement relates are held of record by less than 300 persons.[2] The ABS Release does not expressly address whether, by virtue of Exchange Act Section 15(d), an issuer of a "structured finance product" that relied on the Rule 144A safe harbour could suspend its ongoing reporting obligations after it makes available information equivalent to that which would otherwise be contained in its first annual report, as long as the issuer has less than 300 record holders and does not also have a class of securities registered under the Exchange Act. We expect that this particular question will be clarified during or following the public comment process.*

The end-result of these disclosure rules would be to harmonise disclosure levels in the public and private ABS markets, allowing investors in an exempt private offering of a structured finance product to receive substantially the same level of disclosure as in a registered offering.

New Disclosure Requirements

Proposed Asset-Level Reporting Requirements

Under the proposals in the ABS Release, a public issuer would be required to include detailed asset-level data both in the prospectus at the time of initial offering and in ongoing Exchange Act reports. This asset-level data would have to be provided in a standardised, computer-readable format filed on EDGAR (the SEC's electronic system for data submission) at the time of issuance, whenever new loans or other assets are added to the pool underlying the securities, and on an ongoing basis in periodic reports pursuant to Section 13 and Section 15(d) of the Exchange Act.

The ABS Release establishes general data points, as well as asset-class-specific data points for 11 specific asset classes (residential mortgages, commercial mortgages, auto loans, auto leases, equipment loans, equipment leases, student loans, credit cards, floorplan financings, corporate debt and resecuritisations) that would be required to be disclosed for each asset in a pool. Further, the ABS Release states that resecuritisations issued after the implementation date of the ABS Release would also be subject to the new requirements, regardless of whether the issuance of the resecuritisation's underlying securities predates the implementation date.

[2] As noted in the ABS Release, typically the reporting obligations of asset-backed issuers (other than those with master trust structures) under Exchange Act Section 15(d) are suspended after they have filed one annual report because the number of record holders of each class of its securities is below the 300-record-holder threshold.

Effect on private market: *Given the absence of grandfathering for resecuritisations having underlying securities that were issued prior to the ABS Release's implementation date, sponsors of such resecuritisations in exempt private offerings should begin to determine the type and level of disclosure that would satisfy disclosure obligations under the ABS Release (if adopted in its current form) with respect to an asset-backed security underlying a resecuritisation. A sponsor should plan now its disclosure procedures for any asset-backed security to be resecuritised in the future. In certain cases a private resecuritisation sponsor may wish to expedite resecuritisations contemplated for the near (and possibly intermediate) term so as to achieve completion prior to the effectiveness of any final proposal. Meanwhile, resecuritisation sponsors should consider the other issues raised below regarding the appropriate asset-level disclosure for private offerings in the interim.*

With respect to each individual asset in a pool (or, in a credit card ABS, each group of assets), the issuer would be required to provide specified data, including the terms of the asset, obligor characteristics, interest rates and primary servicer information. Issuers would also be required to update the asset-level data for changes to the pool prior to the date on and after which collections on the pool assets accrue for the benefit of the ABS holders (the "cut-off date"), if the initial data is from an earlier date. These data points would include the current asset balance, the number of days the obligor is delinquent, the number of payments the obligor is past due as of the cut-off date and the remaining term to maturity.

Credit card ABS issuers would be exempt from the foregoing asset-level data disclosure obligations, but would instead be required to disclose grouped account data in the same standardised format.

"An issuer in an exempt private ABS offering should consider now what, if any, additional asset-level disclosure is appropriate to meet its disclosure obligations"

Effect on private market: *Given the detailed asset-level disclosures required by the ABS Release, issuers in certain kinds of exempt private ABS offerings will need to balance their Securities Act disclosure obligations with any confidentiality restrictions that may apply to certain information about those assets. Although the ABS Release envisions disclosures to be in ranges or categories of coded responses to attempt to address this concern, a more granular focus is required to assess permissible disclosure for each data point of each asset class where these and other privacy concerns are present.*

Although the changes in the ABS Release as proposed will not apply retroactively upon becoming effective, in view of the considerable focus in the ABS Release on asset-level disclosure, an issuer in an exempt private ABS offering should consider now what, if any, additional asset-level disclosure is appropriate to meet its disclosure obligations for securities law purposes. Similarly, consideration should be given to implementing other types of disclosures that the ABS Release would require for registered ABS offerings, including the waterfall computer programme, disclosures relating to transaction parties, and static pool information. Even issuers of structured finance products in private placements relying directly on Section 4(2) or "Section 4(1½)" of the Securities Act should consider the effect of these (and other) provisions of the ABS Release on their disclosure obligations and practices.

While issuers in public offerings of ABS in the U.S. would be required to file the relevant asset data (the "asset data file") on Form 8-K at various times during the offering process, including when a prospectus (both preliminary and final) is filed with the SEC and when updating disclosure is otherwise required, the ABS Release does not state that issuers in exempt private offerings of ABS will have to file the asset data file (though it is expected that they would be required to make it otherwise available).

If an SEC registrant experiences unanticipated technical difficulties that prevent the timely preparation and submission of an asset data file, the submission would still be considered timely if the asset data is posted on a website on the same day it was due to be filed on EDGAR, the website address is specified in the required exhibit, a legend is provided in the appropriate exhibit claiming the hardship exemption, and the asset data file is filed on EDGAR within six business days.

Waterfall Computer Programme

Issuers of public asset-backed securities would be required to file on EDGAR a computer programme (the "waterfall computer programme") that gives effect

to the contractual cash flow provisions of the securities in the form of downloadable source code in "Python", which the SEC notes (in the ABS Release) is a commonly used open source and interpretive computer programming language.

The filed source code for the waterfall computer programme would have to provide a user with the ability to input its own assumptions regarding the future performance and cash flows from the pool assets, including assumptions about future interest rates, default rates, prepayment speeds, loss-given-default rates, and any other assumptions currently required to be described under Item 1113 of Regulation AB, in order to facilitate and better enable the investor to conduct its own evaluations. The waterfall computer programme would be required to allow the user to integrate those assumptions with the asset data file that the issuer must make available at the time of the offering and on a periodic basis thereafter.

The waterfall computer programme would also be required to produce a programmatic output, in machine-readable form, of all resulting cash flows associated with the offered securities (including the amount and timing of principal and interest payments payable or distributable to a holder of each class of securities), and each other person or account entitled to payments or distributions in connection with the securities, until the final legal maturity date, all as a function of the inputs entered into the waterfall computer programme. The issuer would be required to file with the SEC an example of the expected output for each tranche based on sample inputs entered into the waterfall computer programme.

Like the asset data file, the waterfall computer programme would be an integral part of the prospectus, as an issuer would be required to provide the waterfall computer programme at the time of filing a preliminary prospectus, with data accurate as of the filing date. Similarly, the waterfall computer programme would be required to be filed with the final prospectus, with data accurate as of that date of filing. An SEC registrant would be entitled to a hardship exemption similar to that described above.

Effect on private market: *Because a waterfall computer programme would very likely be part of the marketing materials provided to prospective investors in exempt private offerings, initial purchasers in Rule 144A offerings, and placement agents in Rule 506 offerings, of structured finance products, which would otherwise have to be filed under new Form SF-1 if offered publicly, should consider what type and level of due diligence would need to be conducted with respect to the waterfall computer programme.*

In addition, regardless of who logistically constructs or designs the waterfall computer programme, an issuer of a structured finance product will nevertheless face significant ultimate exposure and potential liability for the waterfall computer programme, and therefore must perform a proactive role in developing and understanding the waterfall computer programme, irrespective of any proactive role performed by its underwriter or placement agent or its accountants.

Matters Relating to Transaction Parties

Identification of Originator

Regulation AB currently provides that any party that has originated 10% or more of the assets underlying a transaction must be treated as an originator, even if that entity is not affiliated with the issuer or the sponsor. The SEC has expressed concern that this may result in minimal disclosure about originators where a substantial part of the underlying assets comes from third-party originators but no single originator represents more than 10% of the asset pool.

To address this concern, the ABS Release would identify an entity as an originator even if it originated less than 10% of the pool assets, if the cumulative amount of originated assets by parties other than the sponsor (or its affiliates) comprises more than 10% of the total pool assets.

Effect on private market: *This new proposal could limit the attractiveness, feasibility or economic viability of an asset manager accumulating pools of third-party-originated assets with a view to securitisation.*

Expanded Disclosure Regarding History of Assets Repurchased

The ABS Release proposes new disclosure relating to a sponsor's performance history with respect to asset-level warranties. Specifically, an issuer would be required to disclose on a rolling three-year basis the amount, if material, of securitised assets originated or sold by the sponsor or an identified originator that were "put back" to the sponsor or originator for repurchase as a result of a breach of any point-of-sale representation and warranty. This disclosure would be provided on a pool-by-pool basis, together with the percentage of such assets that had not then been repurchased or replaced by the sponsor or originator.

Effect on private market: *Since disclosures relating to the history of "put backs" are proposed to cover a rolling three-year look-back period, as well as contain a breakdown of the amount of assets that were subject to "put back" requests but were not repurchased or replaced, issuers of ABS in exempt private offerings should ensure they have (or take necessary steps to obtain) operational and technical capacity to provide such information.*

The issuer would also be required to disclose whether an independent third party had given an opinion to the trustee confirming that any such assets that had not been repurchased did not in fact violate a representation or warranty.

Financial information about the party required to repurchase a pool asset upon breach of a representation and warranty pursuant to the transaction agreements would also be required, including information about the interest of that party in the securitisation. For example, information regarding the financial condition of an originator that accounts for 20% or more of the pool assets would be required if there is a material risk that its financial condition could have a material impact on the origination of its assets in the pool or on such originator's ability to comply with its repurchase obligations ("put-backs") for those assets. Information regarding the sponsor's financial condition would similarly be required to the extent that there is a material risk that its financial condition could have a material impact on its ability to comply with its repurchase obligations for those assets or could otherwise materially impact the pool.

In addition, for public offerings registered on Form SF-1, the issuer would be required to provide clear disclosure that the sponsor is not required by law to retain any interest in the securities and may sell any interest initially retained at any time.

Prospectus Summary Requirements

The SEC in the ABS Release expressed concern that existing prospectus summaries for ABS tend to describe structural features that are common to all securitisations of a particular asset class, rather than concentrating on the variances that might be material to the specific securities described in the prospectus. The ABS Release contains provisions requiring prospectus summaries to include statistical information relating to the types of underwriting or origination programmes, exceptions to the underwriting or origination criteria and, where appropriate, modifications to pool assets after origination.

Effect on private market: *Issuers in exempt private offerings should plan to adjust private offering disclosure to conform with the public disclosure requirements being proposed. Care will need to be exercised, however, in assessing whether particular requirements conflict with confidentiality restrictions under law or contract or call for commercially sensitive information. For example, it is unclear under this requirement how much detail an originator would have to provide about loans that did not meet its underwriting criteria. Identifying such loans may breach confidentiality provisions and disclosure of certain deficiencies may be commercially sensitive.*

Enhanced Static Pool Disclosure

The current version of Regulation AB introduced the idea of providing investors with historic pool information on a "static" basis. The SEC in the ABS Release has proposed four new disclosure requirements regarding static pool information to be filed on EDGAR:

- narrative disclosure describing the static pool information presented;
- a description of the methodology used in determining or calculating the characteristics and a description of any terms or abbreviations used;
- a description of how the assets in the static pools shown in the prospectus differ from the pool assets underlying the securities being offered; and
- if an issuer does not include static pool information or includes disclosure that is intended to serve as alternative static pool information, an explanation of why that issuer has not included static pool disclosure or why it has provided alternative information.

Static pool information related to delinquencies, losses and prepayments would also need to be presented for amortising asset pools.

Effect on private market: *Whereas, since the adoption of the existing Regulation AB, market practice with respect to most (if not all) asset classes of the exempt private ABS market has been to not include static pool information, under the ABS Release (as proposed) issuers of ABS in exempt private offerings would be required to provide enhanced static pool information and would thus need to consider how to comply with this requirement for each type of asset class.*

Pool-Level Information

Deviations from Underwriting Standards

The issuer's disclosure regarding the underwriting of assets that deviate from the disclosed origination standards (for example, assets that are past due at

the time of inclusion) must be accompanied by specific data about the amount and characteristics of those assets that did not meet the disclosed standards.

To the extent that disclosure is provided regarding compensating or other factors, if any, that were used to determine that the assets should be included in the pool, despite not having met the disclosed underwriting standards, the issuer would be required to specify the factors that were used in that determination and provide data on the amount of assets in the pool that are represented as meeting those factors. An example would be when a very low loan-to-value ratio for a particular residential mortgage loan is considered by the originator to offset a poor credit score on the part of the borrower.

Verification Methods

The issuer would be required to disclose what steps were undertaken by the originator(s) to verify the information used in the solicitation, credit-granting or underwriting of the pool assets.

Modification of Assets

The issuer would be required to include disclosure of the provisions in the transaction agreement(s) governing modification of the assets, disclosure about how modification may affect cash flows from the assets or to the securities and disclosure of whether or not a fraud representation is included among the representations and warranties.

Effect on private market: *To the extent an asset accumulator or asset manager purchases assets in the secondary market with an intent to securitise, it may not have access to the relevant data from the originator(s) of those assets. As such, it is not clear how an asset accumulator or asset manager making such secondary market purchases would comply with these new disclosure requirements under those circumstances.*

Other Disclosure Requirements that Rely on Credit Ratings

The ABS Release would eliminate existing exceptions to disclosure rules which are based on investment grade ratings, including:

(1) removing an instruction to Item 1112(b), which provides that no financial information regarding a significant obligor is required if the obligations of the significant obligor are backed by the full faith and credit of a foreign government and the pool assets are securities that are rated investment grade by a NRSRO; and

(2) removing an instruction to Item 1114 which relieves an issuer of the obligation to provide financial information when the obligations of the credit enhancement provider are backed by a foreign government and the enhancement provider has an investment grade rating.

Effect on private market: *It will be necessary to add corresponding disclosure in exempt private offerings of asset-backed securities and other structured finance products. While the requirements proposed for offerings relying on Rule 144A and Rule 506 are not contemplated to apply expressly to other types of private offerings, market participants must consider the degree, if any, to which an analogous and similar approach should be used in such offerings.*

Issues Regarding "Waiting Period" and Format of Offering Documents

The SEC has expressed concern that shelf programmes generally may have confused investors or presented a lower level of disclosure than stand-alone offerings, because the disclosure relating to the securities is split between a base, or programme, prospectus and a transaction-specific prospectus supplement for each individual issuance. Specifically, in the ABS Release the SEC stated that the use of a base prospectus with a prospectus supplement has resulted in "unwieldy documents with excessive and inapplicable disclosure that is not useful to investors." To address these concerns, the SEC has proposed new Rule 424(h) and Rule 430D as a framework for shelf offerings of asset-backed securities.

With respect to each offering, proposed Rule 430D would require substantially all of the information that was omitted from the form of prospectus (except for pricing-dependent information) to be filed with the SEC at least five business days in advance of the first sale of securities in the offering in a preliminary prospectus that must be in near-final form. As a consequence, the proposals would result in each offering being made on the basis of a single prospectus, rather than the existing base-and-supplement format.

Effect on private market: *As a result of this proposal, issuers of ABS in exempt private offerings may shift towards use of a single offering document and discontinue the use of a base offering document plus supplement.*

Consistent with current practice, under the proposals, the form of prospectus which would be contained in a Form SF-3 shelf registration statement may continue to omit any transaction structure or asset- or pool-specific information or data at the time it is declared effective by the SEC. However, under proposed new Rule 424(h), the issuer would be required to file a preliminary prospectus (a "Rule 424(h) filing" or "Rule 424(h) prospectus") that contains all transaction-specific information about the proposed offering (except pricing-dependent information) at least five business days in advance of the first sale of securities in the offering. This five-business-day period is intended by the SEC to give investors sufficient time to analyze the transaction and loan-level data and run their own scenario analysis using the waterfall computer programme. If the preliminary prospectus is used earlier than such five-business-day period to offer the securities, the ABS Release would require it to be filed by the second business day after first use.

Effect on private market: *In light of this proposed five-business-day waiting period in registered shelf offerings, ABS issuers in exempt private offerings should consider implementing a similar waiting period between the distribution to investors of a preliminary offering document and delivery of a final offering document.*

Proposed Rule 430D would also provide that a material change in the information provided in the Rule 424(h) filing (other than pricing-dependent information), would require a new Rule 424(h) filing and consequently a new five-business-day waiting period.

Effect on private market: *In light of this proposal, ABS issuers in exempt private offerings should consider using a similar waiting period in circumstances where there have been material changes to a final offering document from the preliminary offering document. Issuers of structured finance products in private placements relying directly on Section 4(2) or "Section 4(1½)" of the Securities Act should consider implementing procedures similar to those noted above with respect to waiting periods.*

Similarly, the ABS Release eliminates the exemption for shelf-eligible ABS offerings from the so-called 48-hour rule, which requires a broker or dealer to deliver a preliminary prospectus to any person at least 48 hours before such person is sent a confirmation.

The ABS Release can be found at: http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

Conclusion

Beyond its effects on the public ABS markets, if adopted in its current form the ABS Release will have a significant impact on exempt private offerings of asset-backed securities and other structured finance products that are conducted in reliance on the safe harbours provided by Rule 144A and Rule 506 of Regulation D. The ABS Release would require substantially more disclosure in such offerings than is currently the market practice. The ABS Release is also likely to affect disclosure practices used by market participants in other types of private offerings of asset-backed securities and other structured finance products, such as private placements relying directly on Section 4(2) or "Section 4(1½)" of the Securities Act. By seeking to harmonise disclosure in the public and exempt private markets, the SEC in the ABS Release sends a strong signal that it expects a greater degree of disclosure and other "best practices" in exempt private offerings and sales of asset-backed securities and other structure finance products.

Participants in the exempt private markets for asset-backed securities and other structured finance products will be keenly following the comment process on the ABS Release over the coming weeks and months for signs of the level of acceptance of the proposals contained therein and the chance that they will either be adopted largely in their current form or, alternatively, substantially revised prior to adoption. Regardless of the outcome, the ABS Release justifies a current re-assessment of U.S. private offering practices for structured finance products and is certain to result in fundamental changes in U.S. private offerings of structured finance products in the future.

4. Implications of the SEC Rule 17g-5 for structured finance transactions

In November 2009, the U.S. Securities and Exchange Commission (the "SEC") issued a release[1] containing additional rules regarding conflicts of interest at rating agencies which have been granted the status of "nationally recognized statistical rating organization" by the SEC (each, an "NRSRO").

This release included a controversial new rule (known as Rule 17g-5(a)(3) (the "Rule")), which was intended by the SEC to improve the quality of ratings by increasing transparency, competition, and accountability for NRSROs. The Rule initially had a compliance date of 2 June 2010. This rule-making activity derives from a process that began in June 2008 following the start of the financial crisis when the SEC proposed numerous amendments to its existing anti-conflicts rules applicable to NRSROs and continued through February 2009, when the SEC adopted the majority of these proposals and also re-proposed Rule 17g-5(a)(3) in substantially modified form. On 19 May 2010, after extensive lobbying, the SEC granted a six month exemption for certain non-U.S. transactions from the requirements of the Rule.

Substance of the Rule

Under the Rule, NRSROs that are hired by issuers, sponsors, underwriters, arrangers, or originators (each, an "Appointing Party") to provide credit ratings for structured finance products are required to disclose these transactions to other NRSROs which were not hired by the Appointing Party to provide ratings. The hired NRSRO must provide a list of each structured finance product that it is currently rating on a password-protected website which other NRSROs will be able to access.

The Rule prohibits NRSROs from issuing or maintaining credit ratings on certain structured finance products unless information that is provided to the NRSRO is provided by the Appointing Party to a password protected website which is accessible by other NRSROs. In order to comply with this requirement, NRSROs now require as a term of their engagement, that the Appointing Party must represent to the hired NRSRO that they will provide all of the information given to the hired NRSRO for the purposes of issuing an initial credit rating or undertaking credit rating surveillance on the Appointing Party to all non-hired NRSROs through a password-protected website. The required information includes, but is not limited to, the characteristics and performance of the assets underlying or referenced by the security or money market instrument and the legal structure of the security or money market instrument.

The password-protected website to be maintained by the Appointing Party will only be available to NRSROs that provide a certification to the SEC that they will only access the website to determine or monitor credit ratings and that all materials discovered through the website will be considered non-public and confidential. The non-hired NRSROs can use this information to provide unsolicited credit ratings or ratings solicited by subscribing investors for the given structured product or transaction. The SEC has stated that it believes that this process will provide an independent check on all credit ratings of structured finance products and will reduce what it believes are the adverse consequences of a small number of financial institutions paying for the majority of ratings in this area.

One of the key concerns about compliance with the Rule has been the scope of information required to be disclosed and, in particular, the extent and process in which information provided orally to a hired NRSRO must be disclosed on the Appointing Party's website. Currently, market participants believe that that they should disclose oral statements containing information provided to a hired NRSRO for the purpose of determining or monitoring its credit rating, but the parties may not have to disclose oral communications that are merely operational or logistical in nature. Clarification by the SEC on this point would be welcomed by market participants.

The hired NRSRO must be able to reasonably rely upon the Appointing Party's written representation. Factors to determine reasonable reliance depend on the facts and circumstances of a given situation. These would include ongoing or prior failures by the Appointing Party to adhere to its representations or a pattern of conduct by the Appointing Party where it fails to promptly correct breaches of its representations. The Appointing Party's failure to comply with its representation could lead to the withdrawal of the credit ratings paid for by the Appointing Party and the denial of the ability to obtain future credit ratings from the hired NRSRO. It is the SEC's view that, going

"Currently, market participants believe that that they should disclose oral statements containing information provided to a hired NRSRO for the purpose of determining or monitoring its credit rating, but the parties may not have to disclose oral communications that are merely operational or logistical in nature"

[1] Release No. 34-61050; File No. S7-04-09; 74 Fed. Reg. 63832 (December 4, 2009), http://www.sec.gov/rules/final/2009/34-61050.pdf.

forward, such representations will become a part of the standard contracts entered into between NRSROs and Appointing Parties.

Coverage of the Rule

The Rule applies to NRSROs which have a "conflict of interest" as a result of issuing or maintaining a credit rating for a security or money market instrument that is backed by an asset pool or that is issued as part of an asset-backed or mortgage-backed securities transaction for which the rating is paid by the issuer or underwriter of the security or money market instrument.

The Rule does not provide a territorial or jurisdictional limitation to disclosure. Recently, the SEC issued an order (the "Order") temporarily exempting certain non-U.S. transactions from compliance with the Rule for a six month period (i.e., until 2 December 2010). Specifically, the exemption is available for ratings of structured finance products (i) issued by non-U.S. persons and (ii) where the NRSRO rating the transaction "has a reasonable basis to conclude" that the structured finance product will be offered and sold upon issuance, and that any arranger linked to the structured finance product will effect transactions of the structured finance product after issuance, only in transactions that occur outside the U.S. The determination of "reasonable basis" will depend on the facts and circumstances of a given situation. The SEC notes that, in order to have a reasonable basis to make these conclusions, the NRSRO should discuss with any Appointing Party linked to the structured finance product (i.e., the sponsor, underwriter, and issuer) how they intend to market and sell the structured finance product and how they intend to engage in any secondary market activities (i.e., re-sales) of the structured finance product. The SEC also states that an NRSRO "may choose to obtain from the arranger" a representation upon which the NRSRO can reasonably rely that sales of the structured finance product will meet this condition. Factors the SEC identify as relevant to the analysis of whether such reliance would be reasonable include the following: (1) ongoing or prior failures by the arranger to adhere to its representations; and (2) a pattern of conduct by the arranger where it fails to promptly correct breaches of its representations.

For transactions not covered by the Order, the Rule by its terms applies to ratings for structured finance products issued after 2 June 2010. However, after much discussion in the industry, it has been generally accepted that the actual implementation date will depend on the interpretation given to the Rule by the relevant NRSRO. Each of Moody's, S&P, and Fitch have made statements setting out their interpretation of the implementation date and, interestingly, the agencies have taken slightly different views. Fitch seemed to draw a bright-line – any engagement letters signed and returned to Fitch on or after 2 June 2010 will need to contain the relevant representations by the Appointing Party. Moody's and S&P seem to have interpreted the Rule's implementation in a similar way, but their approach is slightly different to that of Fitch. Moody's stated that where the "rating process has been initiated" on or after 2 June 2010, compliance with the Rule will be required. Following Moody's interpretation, if an engagement letter is dated before 2 June 2010 but sufficient information is only provided to Moody's so that they begin their rating analysis on or after 2 June 2010, compliance with the Rule will still be required. Similar to Moody's, S&P has interpreted the implementation date on the basis that securities for which S&P has sufficient information to begin the ratings process before 2 June 2010, will not be subject to the Rule. Additionally, securities for which S&P currently has insufficient information to begin the rating process but for which S&P does receive sufficient information prior to June 2, S&P will inform the appropriate participants if the transaction will be posted to the password protected website.

Implications for Asset Backed Commercial Paper

The proposed regulations are particularly complicated for sponsors of Asset Backed Commercial Paper ("ABCP") programmes, for which the ratings were issued once at the start of the program, typically many years ago (and therefore would not appear to trigger compliance with the Rule). The SEC believes however that, despite the plain reading of the Rule, the basic provisions of the Rule should nevertheless apply to ABCP programmes, and asked the industry to propose a compliance methodology. Moody's recently stated that it will require ABCP programmes that received an initial rating prior to 2 June 2010 to provide Moody's with a representation that it has posted the following: all programme-level documentation in its then-current form, a copy of the most recent report on programme-owned assets, and all offering documents in their then-current form. This follows a formal proposal to the SEC made by the American Securitization Forum ("ASF"), an organisation which provides information on issues related to securitisations and which represents the interests of arrangers, underwriters, originators and issuers of structured products. Under the ASF's proposal, on 2 July 2010 (i.e., one month after the SEC's required implementation date)

"Practically, ensuring that all information given to hired NRSROs is contemporaneously uploaded to the website will be a complex task"

ABCP programmes would upload historical information on the ABCP programme, including the conduit organisational documents, the administration agreement, the security agreement, the management agreement, the investment guidelines, the programme-wide credit enhancement documents, the forms of liquidity agreement, and the most recent reports of all of the assets. Additionally, the programme would disclose prospective information, including all of the information given to the NRSRO or any contracts with third parties to provide information to the NRSRO. While this propsal has not been approved by the SEC, ASF created this plan following meetings with the SEC to discuss the Rule.

Practical implications for transactions involving structured finance products

While the proposed amendments to the Rule apply to NRSROs, and not directly to the Appointing Parties, if the Appointing Parties do not properly disclose information provided to hired NRSROs, they risk losing their current credit rating for relevant transactions and they may be unable to obtain future credit ratings from the NRSRO. Because many structured finance transactions require credit ratings, such a result would have significant adverse effects on the Appointing Party. As such, the process of posting information to the password protected website is receiving extensive attention among market participants.

Practically, ensuring that all information given to hired NRSROs is contemporaneously uploaded to the website will be a complex task. Appointing Parties will have to be extremely vigilant in ensuring that any written documentation (and any relevant information provided orally) provided to the NRSROs is also uploaded at effectively the same time onto the website. For market participants considering requesting a rating for a transaction which would fall within the scope of the Rule, we strongly recommend developing a compliance process to ensure that the requirements of the Rule are met. Clifford Chance are pleased to advise interested parties in this area.

Conclusion

The SEC proposed amendments to the Rule will significantly alter the relationship between Appointing Parties of structured finance transactions and NRSROs. Requiring Appointing Parties and NRSROs to maintain websites with current information and disclosures will be a challenging undertaking. Many of the details of this Rule are still unclear, and those involved in structured financial markets should continue to monitor the SEC's comments and proposals for updates and clarifications.

5. How the German legislator hopes to save the German financial system

The recently published new policy on certain short-sales has not been the first anti-financial markets crisis measure by Germany and, unfortunately, it will also not be the last one.

On 18 May 2010, the German Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – "BaFin") announced new temporary prohibitions on certain naked short-sales and on 25 May 2010 the Federal Ministry of Finance proposed an even further reaching general ban on short-selling as part of a further amendment to the Securities Trading Act.

Since the onset of the financial markets crisis, regulators and legislators throughout Europe have developed a number of initiatives to deal with its consequences and supposed underlying causes in order to protect the public (and themselves) from the danger of another crisis in the future. This article pertains to certain particularly relevant initiatives of the German legislator and/or regulator during the last year and their practical implications for the structured debt world.

Some of these legislative and regulatory measures are intended to implement European Union law, for example, the changes to the Capital Requirements Directives. Others transpose supranational decisions into German law, such as the G20 countries Financial Stability Board's ("FSB") rules on remuneration in the banking sector which led to amendments to the BaFin's Minimum Requirements for the Risk Management of Banks ("MaRisk"). But some are also of a purely domestic nature (most notably the Financial Markets Stabilisation Fund and the ban on naked short-selling announced recently). Some of these measures are of temporary nature only (such as, again, the Financial Markets Stabilisation Fund), while some are in fact permanent new rules.

All of them have in common that they are intended to help stabilise and strengthen the financial markets. This article gives a summary of the various measures and the current state of implementation.

SoFFin – effort and effect

In October 2008, at the height of the financial markets crisis and shortly after the Lehman Brothers' insolvency, Germany sought to stabilise the financial sector by establishing the German Financial Markets Stabilisation Fund (*Sonderfonds Finanzmarktstabilisierung*, the "SoFFin"). The SoFFin is administered by a public law institution, the Financial Market Stabilisation Institution (*Finanzmarktstabilisierungsanstalt*, the "FMSA") which is attached to Germany's central bank and supervised by the Federal Ministry of Finance. Its objectives are to preserve, stabilise and restructure the financial markets in Germany. Its market-supporting measures (i) are temporary and only available until 31 December 2010; (ii) are available on a voluntary basis; (iii) aim to minimise the potential burden on taxpayers by charging fees for its usage equivalent to market prices; and (iv) promote the adoption by banks of compensation models which do not encourage excessive risk-taking.

The SoFFin was put in place to alleviate (i) the general lack of liquidity, by means of state guarantees for newly issued debt securities and certain other liabilities, (ii) the shortage of capital, by acquiring participations in financial sector enterprises and (iii) the pressure towards depreciation, by assuming risk positions (e.g. liabilities and securities) and granting reliable debt securities issued by the Federal Republic of Germany in return.

The SoFFin has so far provided guarantees of approximately EUR 144 bn to support various banks and provided EUR 28 bn as capital increases in Aareal Bank AG, Commerzbank AG, Hypo Real Estate Holding AG and WestLB AG. Despite charging fees at market rates, the SoFFin recorded a loss of approximately EUR 4 bn in 2009, most of which was apparently related to the support of Hypo Real Estate.

On 23 July 2009, the German Act for the Further Development of Financial Market Stabilisation (*Gesetz zur Fortentwicklung der Finanzmarktstabilisierung*) - came into force and added the "bad bank concept" and the "AidA concept" to the SoFFin's potential range of support measures.

The aim of the bad bank concept was to stabilise the position of banks and other financial institutions by allowing them to transfer any "toxic" assets which came into existence prior to 31 December 2008 to special purpose vehicles (each an "SPV") thereby removing these assets from the relevant institution's balance sheet. Such SPVs would issue bonds backed by these assets to the relevant bank in consideration of the transfer of the assets and these bonds would then be guaranteed by the SoFFin. On the basis of such guarantees, such bonds would also be eligible as collateral for the purposes of the European Central Bank's Eurosystem liquidity scheme.

However, the bad bank concept was not used in practice. Write downs required at the time of the transfer of the assets and the potential suspension of dividend payments required under the SoFFin rules meant that banks were reluctant to use it.

"The SoFFin has so far provided guarantees of approximately EUR 144 bn to support various banks and provided EUR 28 bn as capital increases in Aareal Bank AG, Commerzbank AG, Hypo Real Estate Holding AG and WestLB AG"

Further concerns related to the limitation to "toxic" (instead of illiquid) assets, which have been difficult to identify and which were not the main cause of the crisis, as well as to the lack of tax provisions designed to mitigate the impact on shareholders. Applications for the necessary SoFFin guarantee could only be made up until 22 January 2010 and the bad bank concept is therefore no longer available.

The AidA concept addresses public law banks and allows for the transfer of "toxic" assets as well as of non-strategic business ("risk positions"). Banks (and their SPVs) may transfer risk positions taken prior to 31 December 2008 to a "liquidation institution" *(Abwicklungsanstalt)*. The liquidation institutions may assume risk positions through universal succession by separation or spin-off or through the transfer of assets. Alternatively, the economic risk of a position may be assumed by the liquidation institution through guarantees, trust arrangements, swaps or sub-participation. The transfer of a risk position will only be allowed if the transferring entity or, in the case of an SPV, the relevant bank participates in the losses of the liquidation institution in proportion to its participation. Applications to utilise a liquidation institution in accordance with the AidA concept have been made by Hypo Real Estate and WestLB AG.

The SoFFin may only grant new stabilisation measures until 31 December 2010. However, this does not affect any measures already granted and outstanding on such date and does not prevent further capital participations to support existing stabilisation measures. Eventually, the SoFFin will be unwound and dissolved and any remaining funds will be distributed between the German government and the state governments.

The good bank model, genuinely good?

In addition to stabilisation measures during the crisis there was also a demand for new statutory measures to help prevent future crises by ensuring that key institutions can be more easily restructured, reorganised and/or have key parts of their businesses isolated and transferred. In August 2009, the German government published two drafts (together, the "draft Bill") for a new act on bank insolvency and pre-insolvency rules. The legislative process was, however, put on hold due to the general election in Germany in September 2009. On 31 March 2010, the German Ministries of Finance and Justice jointly announced that, among other measures described in more detail below, they plan to develop proceedings allowing for "voluntary restructuring" as well as for "organised liquidation" of banks. A revised draft of the draft Bill is therefore expected soon.

The old draft Bill sets out three types of pre-insolvency proceedings for "systemically relevant" banks: (i) voluntary restructuring, (ii) reorganisation proceedings and (iii) transfer order to force the relevant bank to transfer the whole or parts of its business to another bank or SPV. "Systemically relevant" institutions are institutions which, due to their size, the intensity of their interbank relations and their close interdependence with foreign countries, could, if they were to fail, trigger significant negative effects at other credit institutions and lead to instability within the financial system.

The draft Bill provides that a systemically relevant institution may apply voluntarily to the BaFin for restructuring proceedings if it no longer has sufficient own funds or liquidity. If the application is approved, a restructuring advisor will implement the restructuring in consultation with the BaFin.

"In addition to stabilisation measures during the crisis there was also a demand for new statutory measures to help prevent future crises by ensuring that key institutions can be more easily restructured, reorganised and/or have key parts of their businesses isolated and transferred"

If the restructuring is not successful, a reorganisation plan may be put in place. The reorganisation plan would provide for the liquidation of the bank and/or the permanent limitations of creditors' and shareholders' rights. In addition, the reorganisation plan would include measures such as the conversion of claims against the bank into equity, capital increases or reductions, changes to the bank's articles of association and the spin-off or hive-down of certain assets and/or business areas to another entity.

Furthermore, the BaFin may order a systemically relevant institution to transfer the whole or part(s) of its key business to another bank or a public law institution *(Übergangsanordnung)* if: (i) the existence of the bank is endangered, in particular if the bank's own funds or liquidity has fallen below 90 per cent of the required ratio or if there are reasons to believe that such a situation will occur; and (ii) this in turn could endanger the stability of the financial system. Should the transferring bank become insolvent, the transfer will be protected from any claw-back provisions under German insolvency laws.

In addition, the draft Bill states: (i) that none of the above measures will entitle a counterparty of the relevant bank to early termination of contractual relationships; and (ii) that contractual clauses which provide for the contrary shall be invalid. However, it is doubtful whether such provisions would be given effect by non-German courts. In addition, the proposed limitations on contractual terminability would create serious doubt as to whether netting arrangements with systemically relevant institutions in Germany would still be enforceable in a crisis scenario. If not, the resulting need to cover the aggregate (rather than the net) exposure to such banks with regulatory capital would place German banks at a significant competitive disadvantage.

It remains to be seen how the issues mentioned above will be reflected in the next draft of the Bill.

More ideas for fallen stars - further government initiatives for failing banks

On 31 March 2010, the German Ministries of Finance and Justice announced further proposals which, together with the draft Bill, are designed to facilitate a quicker and more efficient reaction to turbulence in the financial markets.

In order to ensure that the finance industry itself supports any bail-out and restructuring of banks in any future financial crisis, the German government intends to implement a stabilisation fund *(Stabilitätsfonds)* to be administered by the FMSA. This fund is to be financed by means of a contribution by all German banks, in proportion to the risk posed to the financial system by the relevant bank by reference to the amount of its liabilities (i.e. "too big to fail") or the degree of its connections in the financial markets (i.e. "too interconnected to fail"). However, these proposed measures are the source of substantial debate (including at a global level within the G20).

Given that - in the German government's view at least - the FMSA has had some success, the government further considers that its mandate should be broadened so that, apart from the administration of the stabilisation fund SoFFin, the FMSA could also become responsible for restructuring measures in the banking sector.

Finally, the German Ministries of Finance and Justice have stated in their announcement that the executive boards of credit institutions should take more responsibility in the case of breach of their duties by extending the statutory period of limitation regarding claims resulting from such breaches from five to ten years. This is intended to ensure that claims can still be brought against executive members of stock corporations if the composition of the executive boards has changed in the meantime or such claims became known only at a later date.

A draft law incorporating the above-mentioned measures is expected in the near future.

Stronger supervision under a new statute

The German Act for the Strengthening of the Financial Markets and Insurance Supervision (*Gesetz zur Stärkung der Finanzmarkt- und der Versicherungsaufsicht*, the "Strengthened Supervision Act") came into force on 1 August 2009 and primarily amended the German Banking Act (*Kreditwesengesetz* - "KWG") and the German Insurance Supervisory Act (*Versicherungaufsichtsgesetz*). The following is a summary of the main amendments that affect credit institutions and financial services institutions (each an "institution").

The power of the BaFin to impose higher individual capital requirements on an institution or a group of institutions has been extended, in particular: (i) to account for risks that are not currently subject to regulations; (ii) if the "risk-bearing capacity" of the institution is no longer ensured; (iii) to create an additional "equity capital buffer" during an economic downturn; and (iv) to account for special business circumstances. In addition, the BaFin can impose higher capital requirements as a pre-emptive measure rather than a measure of last resort in respect of shortcomings of an institution's internal business organisation.

In addition, the BaFin is now authorised in certain circumstances to individually impose higher liquidity standards in order to safeguard an institution.

The BaFin now has the power to impose a ban on payments by an institution to its intragroup creditors ("ring-fencing") if it concludes that the discharge of the institution's obligations vis-à-vis its creditors or the safety of the assets entrusted to it are at risk or that effective supervision is not safeguarded. The purpose of such a ban would be to prevent a German institution from being deprived of liquidity by its (non-German) parent company or affiliates, a problem which for example arose during the collapse of Lehman Brothers.

The distribution of profits to shareholders can also now be prohibited if there is a danger of the institution falling below (rather than an actual failure to meet) the supervisory ratios in respect of the institution's own funds or liquidity. Moreover, the BaFin is authorised to prohibit the repayment and distribution of profits in the context of hybrid capital instruments.

In general, the Strengthened Supervision Act therefore allows for severe limitations

"The biggest danger for the future of the financial markets in Germany as well as in Europe and globally is currently that the underestimated aggregate of all these many good or well-intended new rules completely overburden the market players and effectively encumber the desperately needed recovery of the markets"

of shareholders' rights based on a mere forecast of an institution's ability to fulfil supervisory requirements. It also stipulates that conflicting contractual rights of holders of equity instruments are not enforceable. Furthermore, the BaFin is now able to prohibit or restrict "accounting measures that serve to outbalance an annual net loss or to disclose an annual net profit". All of these measures apply to superordinate companies (*übergeordnete Unternehmen*) of financial holding groups and of groups of institutions. In certain circumstances these measures can be taken without provision of a transitional period.

The Strengthened Supervision Act introduces detailed reporting requirements for institutions which are intended to extend the BaFin's information database to enable it to better identify risk concentrations within groups of institutions. The superordinate company of a group of institutions is obliged to disclose to the BaFin certain intragroup transactions that reach or exceed 5 per cent of the amount of own funds required at group level. In addition, ad-hoc reporting is required with respect to any transaction that might endanger the adequacy of the superordinate company's own funds. The Act also requires institutions and groups of institutions to report regularly on their "leverage ratio" which is intended to help detect additional on- or off-balance sheet risk potentials.

The Strengthened Supervision Act also introduces certain qualification requirements for members of the supervisory boards of companies in the financial sector.

Other developments

Other initiatives that are being brought in or that are under consideration include:

- the draft bill for the implementation of CRD 2 including provisions regarding re-securitisation from the current CRD 3-proposal whose adoption has been postponed;
- the announcement of the German government on 23 February 2010 that it will consider introducing a "Securitisation Act" to set out "uniform and transparent standards for asset-backed securities";
- the draft bill for the implementation of Regulation (EC) No 1060/2009 on credit rating agencies, which provides for an annual audit to be performed by auditors appointed by the BaFin; and
- the discussion draft of the Federal Ministry of Finance for an "Act to Strengthen Investor Protection and Enhance Functionality of the Capital Market" published on 3 May 2010, providing for the following key measures:
  - stricter investor protection standards in the "grey capital market";
  - new compliance requirements for investment advisors and persons exerting influence on distribution targets;
  - prohibition of naked short selling transactions (and a mandatory reporting system for covered short sales);
  - disclosure requirements for cash-settled derivatives (aiming to prevent an unnoticed "sneaking-up" on German listed companies); and
  - minimum holding periods and enhanced liquidity requirements for open-ended real estate investment funds.

These other initiatives, together with the draft Pre-Insolvency Bill (not to mention other supranational and European legislative or regulatory projects, such as for example the clearing of over-the-counter derivatives via exchanges or other central counterparty systems), mean that the German financial sector, already traditionally one of the most highly regulated markets in the world, will continue to be subject to constant change and increasingly stringent requirements, and that German legislative initiatives will remain of interest to the structured debt world for the foreseeable future.

In summary, it is fair to say that some of the German legislative or regulatory measures introduced to stabilise and revitalise the financial markets have been more appropriate and more successful than others, and it looks as if the same holds true with respect to the forthcoming legislative and regulatory projects. The biggest danger for the future of the financial markets in Germany as well as in Europe and globally is currently that the underestimated aggregate of all these many good or well-intended new rules completely overburden the market players and effectively encumber the desperately needed recovery of the markets. As for the industry, finger-crossing might not be sufficient to avoid this undesired result.

6. Significant risk transfer and synthetic securitisation

One issue which has been attracting the market's attention recently is what constitutes "significant risk transfer" for the purpose of treating a qualifying transaction as a synthetic securitisation under BIPRU Chapter 9. This attention is largely the result of two letters which the Financial Services Authority ("FSA") sent to the British Bankers' Association on 24 July 2009 and 26 February 2010, in which it expressed an interpretation of the relevant provisions of BIPRU which is at odds with the way most market participants had previously understood the scope of those rules, and which poses a number of issues for originators seeking to reduce their regulatory capital requirements by utilising synthetic securitisation techniques.

This FSA letters affect both traditional, funded synthetic CLO transactions, as well as funded or unfunded private transactions which provide credit risk mitigation under BIPRU 5.7.[1]

In order to qualify as a synthetic securitisation, a transaction needs to meet the requirements of both Chapters 5 and 9 of BIPRU. For the purposes of this article, the key requirements in Chapter 9 are that the transaction must have a tranched capital structure, and that the transaction must provide significant risk transfer. However, in contrast to a "cash securitisation", the mechanism by which this risk transfer is achieved is by means of a credit risk mitigant (such as a credit default swap or a guarantee) which must also comply with the requirements for obtaining regulatory capital relief pursuant to Chapter 5 of BIPRU.

While the issue of what constitutes significant risk transfer initially arose following the FSA letters, it has recently been taken up by other European regulators, some of whom have followed a similar approach to the FSA.

The original issue

The FSA's concern originally arose in response to transactions in which the aggregate of the premium payable by the originator (as buyer of credit protection) was equal to, or exceeded, the maximum loss which could be suffered by the seller of credit protection under the transaction. The effect of this was that, unless the buyer defaulted in its payments of premium, the seller would never lose money over the life of the transaction. This was often coupled with a rebate mechanism whereby if, at the maturity of the protection period, the aggregate of the premium paid over by the buyer exceeded the losses suffered on the reference portfolio, that excess (less a profit to be retained by the seller) would be returned to the buyer. This had the effect of ensuring that, except in relation to the seller's profit element, the buyer would not end up paying out more than the actual losses suffered by it on the reference portfolio. The combination of these features was that the buyer was effectively still exposed to the maximum potential losses on the portfolio. It would seem that the FSA's concern with this type of transaction was that it did not appear that the buyer had actually transferred any risk in the reference portfolio to the seller. All that it had done was transform the timing of those losses. Whereas, without the transaction it would suffer the losses as and when they occurred, with the transaction in place, the buyer would be required to make pre-determined payments at pre-determined times, regardless of when the losses actually occurred.

This is not to say that such transactions may not still serve a useful purpose. While over time, the buyer does remain exposed to the losses on the reference portfolio, the time shifting of its payment to the seller does radically transform the impact which losses will have on the buyer, and its ability to cover those losses from its capital reserves without threatening its financial stability. By removing the timing uncertainty, the originator can provision more efficiently to meet those losses. The rationale for holding capital against risk weighted exposures is to guard against the timing *uncertainty* associated with whether or not those exposures will default. By transforming that uncertainty into a stream of known and limited payments, the originator need not hold capital against the entire exposure. Rather, the premium payments will simply be an entry in the buyer's profit and loss account, and therefore result in a reduction in tier 1 capital to the extent payments are made.[2] Nevertheless, it appears that the FSA had significant concerns with this type of transaction, leading it to pay closer attention to transactions which, while not always as extreme as this example, do involve the originator bearing a significant cost of protection.

While this article is primarily focussing on the regulatory capital position of the

[1] The FSA letters also addressed number of other issues related to synthetic securitisations such as the effect of incentives to unwind transactions early and proposed future amendments to the CRD. However, this article focuses on an analysis of the FSA's position on significant risk transfer.

[2] This does not address possible concerns about how the seller of protection might be reporting the transaction. However, this article is concerned primarily with the position of the originator, not the seller.

originator, it is interesting to note that, where the protection seller is also a regulated entity, it is possible to see how this could give rise to a regulatory asymmetry. It would usually be expected that, as a consequence of entering into the transaction, the buyer would report a reduction in its risk weighted exposures as a result of the protection received from the synthetic securitisation, while the seller would take those risk weighted exposures onto its balance sheet, and hold capital against them accordingly. However, given that the seller cannot suffer a net loss (unless the originator defaults in its payments of premium), the seller could argue that its only exposure is to the buyer which, as exposures to credit institutions attract only a 20% risk weighting, would generate a lower capital requirement than an exposure to the reference portfolio itself. The result is that, when the positions of the buyer and seller are combined (both being regulated entities), the total risk in relation to the reference portfolio remains unchanged. However, the amount of capital now held against that risk has been reduced significantly, with the both the buyer and the seller holding capital against exposures to each other and no one holding capital against the reference portfolio.

The FSA's response

While the FSA's concerns may have begun with transactions where the aggregate premium payable would match the maximum potential losses, the impact of its response is being felt much more broadly. The FSA has chosen to focus on the requirement in BIPRU 9.3.2G that "the transfer of credit risk to third parties should only be considered significant if the proportion of risk transferred is broadly commensurate with, or exceeds, the proportion by which the risk weighted exposure amounts are reduced". It then

"The transfer of credit risk to third parties should only be considered significant if the proportion of risk transferred is broadly commensurate with, or exceeds, the proportion by which the risk weighted exposure amounts are reduced"

adopts a "substance over form approach" to the determination of whether the transaction does in fact result in the transfer of credit risk to the seller of credit protection.

It would seem that the FSA has taken this approach at least partly out of a desire to present its response as merely reinforcing what has always been the case – that is, that in order to obtain regulatory capital relief under a synthetic securitisation, the transaction must provide significant risk transfer. From its perspective, all it has done in its letters of 24 July 2009 and 26 February 2010 is provide further colour on what constitutes significant risk transfer in this context.

In its letter of 26 February 2010, the FSA identified three particular features of a transaction which may result in it determining that the amount of risk transferred is less than would otherwise appear to be the case:

- first, where the amount of premium payable is "guaranteed", or fixed, such that it does not reduce as losses are incurred on the portfolio. This could take the form of either an upfront premium or a premium which is calculated at a fixed percentage of the initial notional amount of the transaction, regardless of whether or not losses have occurred, and is to be contrasted with a variable premium which is a function of the residual performing balance of the tranche;
- secondly, a premium which is significantly greater than the credit spread income on the assets in the portfolio or which, in aggregate, is similar to the size of the protected tranche itself; and
- thirdly, where the originator effectively retains exposure to the expected loss through higher transaction costs which are payable to the seller, whether by way of premium or otherwise.

The FSA goes on to state that "[w]here a transaction has no explicit tranching, but the terms (e.g. guaranteed premium) economically result in there being an implicit retained position or economic tranching, the transaction should be treated as a securitisation under BIPRU 9." It is not clear exactly what the FSA means by this statement. One interpretation is that this is intended to refer to any transaction which is not itself tranched, even if that transaction only references a single tranche of a broader capital structure. However, such transactions should already be considered tranched for the purposes of Chapter 9 of BIPRU. It is therefore likely that this statement is intended to apply to untranched transactions which cover the entire capital structure of a reference portfolio. As such transactions would not normally constitute securitisations, they would not be subject to the requirements for significant risk transfer under Chapter 9 of BIPRU. Rather, they would only be required to comply with Chapter 5 of BIPRU, which has no such requirement. If it is the FSA's intention to treat such transactions as securitisations, then the

effect of this would be that a transaction covering the entire capital structure of a portfolio, but which had, for example, a guaranteed premium, would no longer be eligible to provide regulatory capital relief as a result of the requirement in BIPRU 9.1.3 to calculate the risk weighted exposures in relation to a securitisation position in accordance with Chapter 9 of BIPRU coupled with the limitation in BIPRU 9.3.1 which only permits the use of reduced risk weighted exposures where the transaction achieves significant risk transfer.

Despite the FSA stating that it is concerned about whether or not there has been significant risk transfer, this is, in practice, a blunt instrument, and not necessarily the most appropriate way of approaching these transactions. Undoubtedly, risk has been transferred. It is now the seller who is exposed to the losses on the portfolio, whenever they happen to occur. The real issue is not whether or not there has been significant risk transfer (which is a binary determination), but rather whether the way in which that risk has been transferred has occurred means that there is implicitly an additional tranche of retained risk or some other retained position which must be deducted from capital. In the case of transactions such as those described above where the premium matches the maximum losses on the transaction, the size of that implicit retained position would indeed be too large to leave room for significant risk transfer in relation to the transaction.

However, in many other cases, the position may not be so extreme, such that it would be an overreaction to disallow the recognition of the entire transaction for the purposes of BIPRU 9. This would also tie in rather neatly with the proposed amendments to the Capital Requirements Directive which will introduce more explicit thresholds for determining exactly how much risk must be transferred in order for a transaction to qualify as significant risk transfer. Anecdotal evidence suggests that this is, in fact, the way in which the FSA is approaching such transactions. Rather than disqualify a transaction outright, it is requiring adjustments to be made to the amount of regulatory capital relief generated by the transaction to take into account the effect of a significant upfront premium, etc.

Concerns with the FSA's position

The FSA's approach does highlight the fine line that exists between the cost of credit protection and credit enhancement. That is, if the cost of purchasing credit protection is a function of the expected losses on the portfolio, then that cost can be reduced by credit enhancements (such as a synthetic excess spread or a first loss tranche) which reduce those expected losses. An originator can, therefore, either pay a higher premium, or support the structure with other types of enhancements. Where the transaction incorporates a rebate mechanic along the lines discussed above, the economic effect for both the originator and the seller will be substantially the same, whichever approach is followed, although this will not necessarily be the case in a transaction without a rebate mechanism, where the seller is likely to receive a greater return by way of an increased premium than it would from other forms of credit enhancement. This realisation demonstrates that it is unlikely to be in the originator's interest to agree to a higher premium rather than employ other forms of credit enhancement, as the ultimate cost to the originator will end up being greater. This suggests that if a high premium is being paid, it is simply because that is what the market demands in order to provide credit protection on the relevant reference portfolio. In light of this, it is perhaps surprising, albeit understandable, given the nature of the transactions which initially gave rise to its concerns, that the FSA has chosen to focus on whether there has been significant risk transfer rather than on whether the way in which the premium (and any potential rebates) have been structured is such as to constitute a type of credit enhancement.

"Anecdotal evidence suggests that rather than disqualify a transaction outright, the FSA is requiring adjustments to be made to the amount of regulatory capital relief generated by the transaction to take into account the effect of a significant upfront premium"

Nevertheless, however the FSA chooses to classify its approach, it does cause a number of concerns, which potentially undermine an originator's ability to enter into a synthetic securitisation transaction at all.

Most obviously, by treating a premium as akin to a retained first loss tranche where that premium is either guaranteed in all (or most) circumstances or is significantly greater than the spread income on the assets in the reference portfolio, it may actually become impossible for an originator to obtain significant risk transfer in respect of a reference obligation or portfolio. Consider, for example, a reference portfolio comprising commercial real estate loans that were originated with relatively low spreads prior to the onset of

the financial crisis. Given the decline in commercial real estate values since then, it is likely that the cost of purchasing credit protection in respect of such a reference portfolio could now be significantly greater than the spread generated on the portfolio. However, the FSA's approach would appear to suggest that, to the extent that the originator is required to pay this higher cost to purchase credit protection, it will not be permitted fully to recognise significant risk transfer in respect of the reference portfolio. Perversely, as the asset deteriorates, and it becomes more expensive to purchase credit protection, it will become harder for the originator to satisfy the FSA that the credit protection does in fact result in significant risk transfer.

The focus on a "guaranteed" premium (that is, a premium which remains constant throughout the life of a transaction, despite losses being incurred on the portfolio) can, in some circumstances, also result in the originator actually being required to pay a higher premium than would otherwise be the case. This is because the originator and the seller may have a different view of the rate and frequency at which losses will occur on the portfolio. Where the premium is expressed as a percentage of the performing balance of the portfolio, the seller may be inclined to assume losses will occur rapidly, and therefore will demand a higher premium in order to ensure it generates its desired overall return over the life of the transaction. On the other hand, the originator, which is ultimately in the best position to gauge the likely rate at which losses will occur on the portfolio, may expect that those losses will occur at a much slower rate. On this basis, it may be in both parties' interests to structure the premium as a guaranteed coupon, whereby the seller has certainty that it will receive its desired overall return, but the buyer is protected from the risk that it will end up paying much more for the protection if it is correct and the losses accrue more slowly than the seller anticipates. The ultimate irony of this is that the FSA's dislike of a guaranteed coupon approach may actually result in the originator having to pay a higher premium which, of course, puts it at risk of breaching the FSA's other concern, namely a premium that is significantly greater than the spread generated by the reference portfolio itself. Thus, the originator finds itself unable to achieve a complete risk transfer in respect of the reference portfolio.

> "By treating a premium as akin to a retained first loss tranche where that premium is either guaranteed in all (or most) circumstances or is significantly greater than the spread income on the assets in the reference portfolio, it may actually become impossible for an originator to obtain significant risk transfer in respect of a reference obligation or portfolio"

Where to from here?

There are two clear messages which come out of the FSA's position on these transactions. First, that it is concerned about market participants taking advantage of potential gaps in the regulatory framework to exploit perceived arbitrage opportunities. Second, that to address this concern, the FSA will be taking a much more interventionist and hands-on role in determining whether to allow originators to recognise such transactions as synthetic securitisations for regulatory capital purposes.

The wide-ranging impact of the FSA's response appears to be deliberate, while also being sufficiently broad as to provide scope for individual transactions to be approved where the FSA is satisfied that they are consistent with its interpretation of the spirit of BIPRU. It is, therefore, difficult to state categorically, for example, at what point a premium is too high. Rather, in place of such black and white rules, originators will need to engage in a dialogue with the FSA, in which they will need to be able to demonstrate how they have determined the pricing and timing of payments which will apply to a particular transaction and why that structure is appropriate in light of the prevailing market conditions.

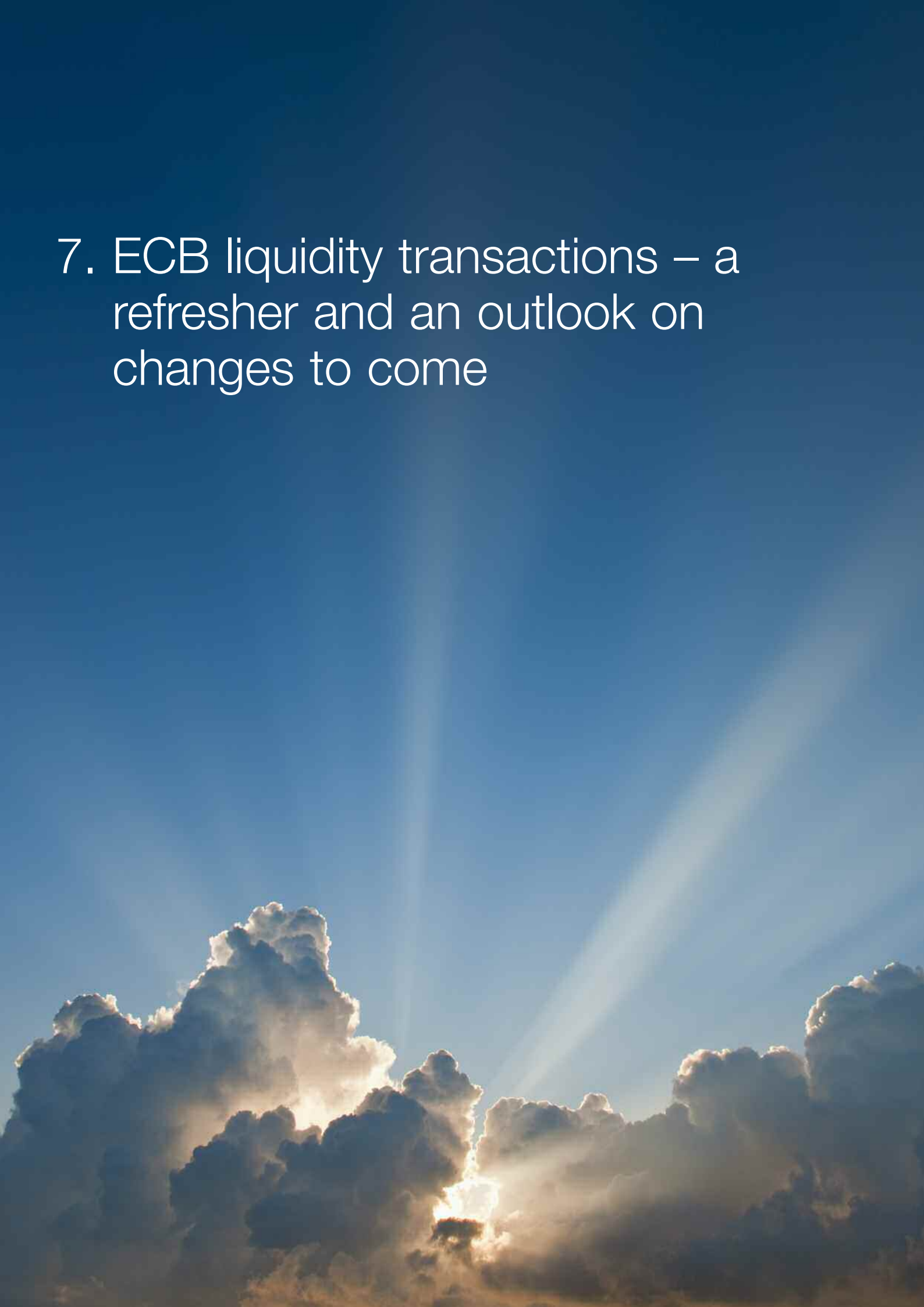
The FSA has been quite explicit that it expects firms to approach it at an early stage to discuss proposed transactions. If a firm does not do so, the FSA will expect the firm not to claim any regulatory capital reduction from those transactions in any market disclosure without also including a warning about the risk of reassessment of the regulatory capital relief provided by the transaction if that risk "is material in light of [the FSA's] stated policy". Unfortunately, as is apparent from the discussion above, this risk would seem to be material in respect of any transaction where the structure is any more complicated than a simple periodic premium, which is lower than the spread on the reference portfolio and which is calculated against the performing balance of the portfolio.

Beyond the UK

While we are not aware of any other regulators publishing a formal public position on these issues, anecdotal evidence suggests that the FSA's position has resulted in a number of other European regulators also revising their treatment of these transactions. Some appear to be following the FSA's stricter approach, while others have not, at least to date. It will be interesting to see how this issue develops, particularly in the context of the proposed changes to the Capital Requirements Directive. The FSA has, so far, stated that it does not expect these amendments will change their policy objectives on significant risk transfer. Whether other regulators will use these amendments as a catalyst for a revised approach remains to be seen.

"The FSA has been quite explicit that it expects firms to approach it at an early stage to discuss proposed transactions"

7. ECB liquidity transactions – a refresher and an outlook on changes to come



This article looks at the rules governing collateral eligibility for the European Central Bank's ("ECB") liquidity scheme, which has been a lifeline to the market over the last few years. We discuss ECB rule changes and offer our observations as to where future changes may be made.

As the ECB's rules change from time to time, it is important to ensure that there is enough flexibility in deal documentation to allow for continued eligibility following a rule change.

The ECB's scheme

The ECB has provided critical liquidity to the market over the last few years. A cornerstone of its liquidity operations has been its rules regarding the types of assets it will accept as collateral for liquidity purposes. In this article, we look at the rules as they have been implemented over the last few years and discuss the further changes which may be introduced by the ECB to try to wean the market off its liquidity operations and to encourage a return to market financing.

Eligible assets – a refresher

The ECB accepts two types of assets as collateral for its liquidity schemes – marketable assets and non-marketable assets.

Marketable assets generally include:

- corporate bonds with an issuer or guarantor rated "A" or above;
- ABS rated "AAA"; and
- regulated covered bonds rated "A" or above.

Non-marketable assets are essentially credit claims (for example, loans) and non-marketable retail mortgage-backed debt instruments.

What isn't eligible?

A number of factors may render particular securities ineligible. The main ones being:

- an issuer established outside the EEA and any of the other non-EEA G10 countries (which means that securities issued by Cayman Islands or Jersey SPVs are ineligible);
- bonds and covered bonds not having a rating from one recognised rating agency or, in the case of ABS, not having ratings from two recognised rating agencies;
- the currency not being euro, or (until the end of 2010) sterling, US dollars or yen;
- the securities not being the most senior tranche;
- for ABS issued after March 2009, the underlying assets comprising asset backed securities;
- for ABS, the acquisition by the issuer of the underlying collateral for the ABS not being a "true sale" governed by the laws of an EU member state; and
- securities not being admitted to trading on a regulated market (or certain non regulated markets as specified by the ECB).

Close links – further tightening?

Counterparties wishing to use the liquidity scheme cannot have "close links" with the issuers of the securities they want to use as collateral. The primary prohibition is on submitting collateral which a counterparty has issued or guaranteed itself. There are also other rules prohibiting other types of "close links", such as the rule that if a counterparty submitting collateral provides any foreign exchange hedging to the collateral, such collateral will not be eligible. To date, counterparties providing interest rate hedging, or liquidity support of up to 20% of the relevant transaction, have not fallen foul of the "close links" rule. In addition, a counterparty servicing assets has not been regarded as having a "close link" with the securities being submitted for collateral purposes. While there has been no official announcement in relation to any tightening of these rules, there is speculation that the close links rules may be further tightened in future.

"Consideration should be given to the inclusion in the transaction documentation of provisions allowing for a change of interest rate counterparty or liquidity provider should that become necessary to comply with any new "close links" rules"

To guard against a transaction ceasing to be eligible for ECB liquidity purposes, consideration should be given to the inclusion in the transaction documentation of provisions allowing for a change of interest rate counterparty or liquidity provider should that become necessary to comply with any new "close links" rules.

True sale

For ABS to be eligible, the transfer of the underlying assets to the issuer must be a "true sale". This requirement is well known and national central banks routinely request legal opinions from the national central bank in the jurisdiction under the laws of which the true sale is to be achieved in order to confirm the true sale analysis. However, there have been some extensions of the true sale requirement in particular deals which have been challenging for market participants to satisfy.

Traceability of "true sale" to origination and underlying assets: Historically, for true sale purposes, the national central banks have (in line with the text of the rules) never looked further back than the sale of the assets from the originator to the issuer of the securities. However, in recent transactions, this approach has been changing. For CDOs of ABS issued before March 2009, requests have been made for comfort that not only was the sale to the issuer of the underlying ABS a true sale but also that the underlying ABS themselves were true sale transactions (a very difficult requirement to satisfy unless the counterparty requesting eligibility had arranged the underlying ABS transactions and could provide the true sale legal opinions delivered in relation to them). There was nothing in the rules which suggested that such an interpretation might be made and an extended application of the rule without warning was not a welcome surprise. In addition, we are aware of CLO transactions where true sale comfort has been required, not only in relation to the sale by the originator of a portfolio of loans to the issuer of the securities, but also in relation to the originator's own acquisition of individual loans from the market. Again, it came as a surprise to the market participants in those deals when the national central bank extended the true sale requirement beyond the sale of the underlying collateral by the originator to the issuer of the securities.

Originator trusts: The legal status of originator trusts in English law equates to that of a "true sale" and structures using English law trusts have been accepted by national central banks on many occasions. That said, there has been one instance which we are aware of where an Austrian originator trust structure was rejected as being ineligible by the relevant national central bank. Although we do not anticipate any issues with tried and tested originator trust models (Austrian law is different to English law) there is a possibility that national central banks may analyse the legal aspects of trusts and how readily they equate to a "true sale" in more depth going forward.

National central bank arbitrage

The central bank of the country where the securities being submitted are listed gets the job of determining whether or not the relevant securities will be eligible for collateral purposes.

Market participants have sometimes noticed apparently different approaches being taken by the various national central banks over the interpretation of eligibility criteria and turn-around times for applications. As a result, counterparties have occasionally tried to arbitrage these differences in order to achieve a particularly fast turn-around or the acceptance of a particular type of asset. The differences in approach were broadly attributed to the fact that the national central banks are generally very separate from each other and did not (or did not appear to) have a particularly joined-up approach.

Recently, the degree of communication between national central banks has greatly increased and as a consequence of this their interpretation of the eligibility criteria has become more uniform. Accordingly, it would appear that the opportunities market participants may have had for central bank arbitrage have largely disappeared.

In terms of organisation, the national central banks have started to allocate certain tasks to one of their number to allow for greater consistency in application across member states. For example, the French national central bank centrally decides on the theoretical value of securities the value of which cannot be determined in the market and where a theoretical valuation needs to be made.

Asset valuations

The absence of any real market for many ABS means that theoretical values have to be assigned to such securities in order for the ECB to be able to calculate how much it can lend against those securities. In some instances, the values attributed by the ECB to ABS submitted for collateral purposes have been significantly less than par. Counterparties faced with low valuations have sometimes been successful in obtaining a higher valuation, particularly where the issuer of the receivables has agreed to provide enhanced disclosure on the underlying assets.

Among other things, to assist with valuation of ABS submitted as collateral, it is now clear that the ECB will publish new requirements stipulating minimum ongoing disclosure standards regarding underlying assets that will need to be adhered to. A public consultation on the establishment of loan-by-loan information requirements for ABS in the Eurosystem collateral framework closed on 26 February 2010. On 22 April 2010, the ECB announced that the study phase for its loan level data initiative can be considered complete and that the Eurosystem will now proceed with its preparatory work for such loan level information requirements. This preparatory work is expected to last approximately 6 months and it is currently envisaged that market participants will have a 12-month adaptation period before having to submit loan level data.

The current ECB plans set forth that loan level data should not only be available to the Eurosystem but also to the wider market, thereby helping to restore "confidence in the securitisation markets". It is intended that the required disclosure

"With the financial recovery that appears to be under way, we expect a tightening of the rules on what will constitute eligible collateral going forward"

should be an ongoing one (over the full life time of the relevant ABS) and that standardised asset-specific templates should be used. So far a draft loan level template for RMBS has been prepared.

The forthcoming ECB requirements on loan level data disclosure will inevitably place further administrative burdens on those having to provide such information, both in terms of updating IT systems and data collection. Such standardised loan level reporting can reasonably be implemented only with respect to newly originated assets where the originators have had a chance to reflect the new Eurosystem requirements in the origination process. For already existing assets and/or transactions, the information requested in the future may not be available or may only be available embedded in IT systems or reporting formats which are incompatible with the future ECB reporting templates. Therefore, a sufficiently long grandfathering period (or at least rules for some discretion in this regard) will be essential.

Grandfathering

The grandfathering of changes to the ECB's eligibility criteria is not guaranteed. In instances where grandfathering is not permitted, transactions which satisfied the criteria at the time they were put into the scheme may no longer do so and would need to be withdrawn if they do not comply with the new rules.

If changes are not grandfathered, sufficient prior notice may be given so that market participants are not taken by surprise. For example, additional haircuts to ABS transactions and changes to the close links rules came into force on 1 February 2009 with no grandfathering, although prior notice had been given to the market that these changes would be made.

An example of when changes were partially grandfathered was in March 2009 when ABS of ABS and CDOs of ABS became ineligible. However, the ECB grandfathered the use of these types of assets until 1 March 2010 provided they were issued prior to 1 March 2009. As of 1 March 2010, all ABS of ABS, or CDOs of ABS, have ceased to be eligible for collateral purposes.

Two Ratings

One of the recent changes to the ECB rules which has had a significant impact has been the introduction of the requirement that ABS should have two ratings to be eligible. This rule change was publicised in November 2009 and, for ABS issued on or after 1 March 2010, such ABS will need to have two "AAA" ratings at issuance (each of which may drop to "A" over the life of such ABS and still remain eligible).

For ABS issued before 1 March 2009, it is sufficient if one rating which remains "A" was obtained at issuance. However, from 1 March 2011, ABS issued prior to 1 March 2009 will not be eligible unless such ABS has obtained an additional "A" rating.

For ABS issued between 1 March 2009 and 1 March 2010, such ABS will only be eligible if assigned a "AAA" rating at issuance (which can drop to "A" over the life of such ABS). In addition, from 1 March 2011, for ABS issued between 1 March 2009 and 1 March 2010, an additional rating of at least "A" will be required for such ABS to remain eligible.

It is expected that many transactions will need to be restructured prior to 1 March 2011 to ensure the continued eligibility of such transactions for the ECB's liquidity scheme.

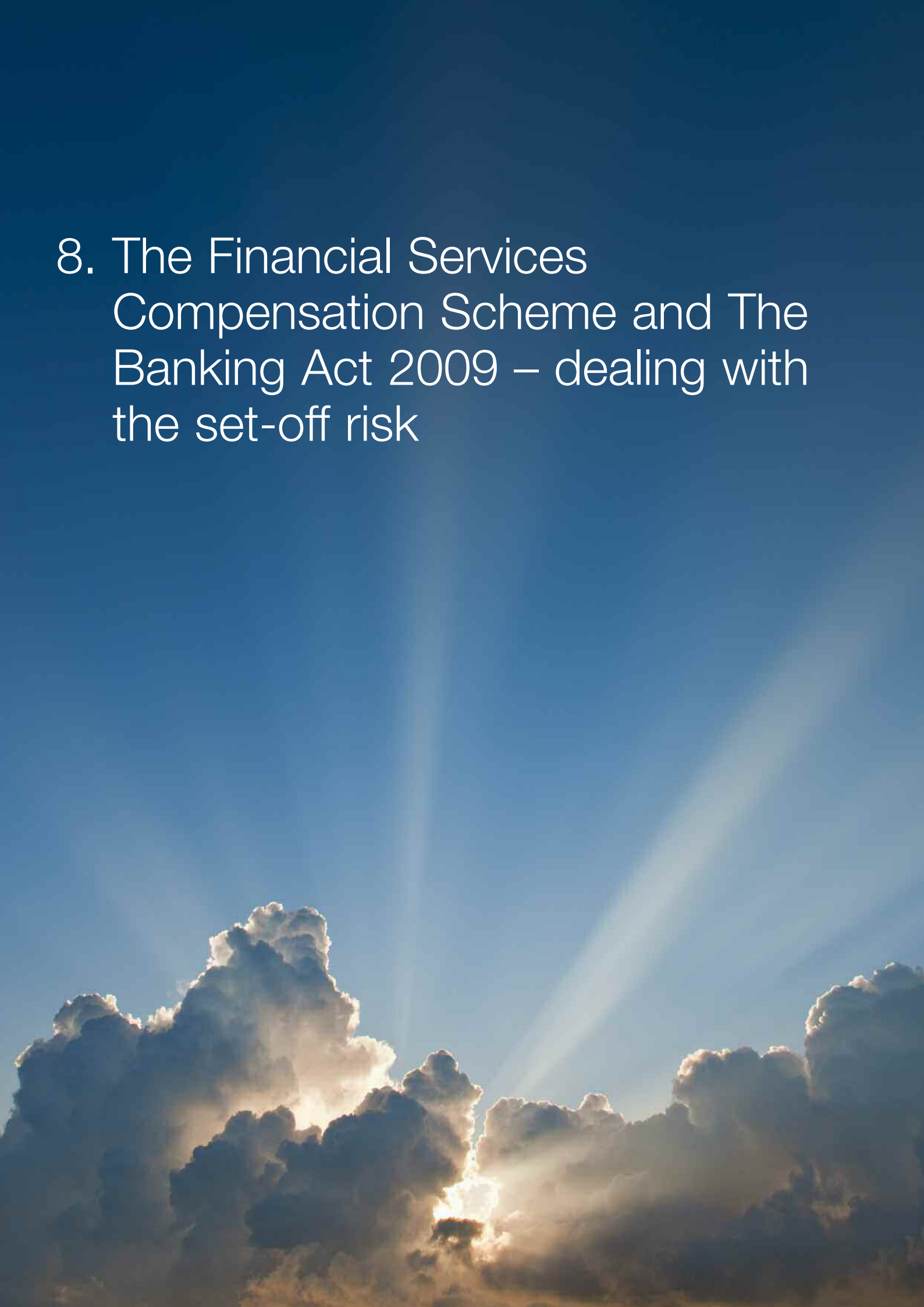
Secured structures using non-ABS criteria

As there are different eligibility criteria for ABS on the one hand, and corporate bonds and covered bonds on the other, there may be scope for structuring assets into one category if they do not fit into another. For instance, ABS securities require an "AAA" rating to be eligible, but this is not of course always possible. For such transactions, one entity (with an "A" rating itself or issuing with the benefit of a guarantee from an entity with an "A" rating) could issue bonds guaranteed by an SPV. The guarantee from the SPV could be secured on the underlying assets, in a similar way to what happens in many covered bond transactions (but without the issuer actually being required (or able) to satisfy the requirement to issue a regulated covered bond). With this type of structure, assets not capable of backing an "AAA" rated ABS can be used to support or enhance an obligation issued by an entity (or guaranteed by an entity) with an "A" rating, without the structure falling within the ABS rules and, therefore, without the need to get an "AAA" rating and provide a true sale opinion.

The future

The ECB's open market operations were never intended to be a permanent form of financing for credit institutions. With the financial recovery that appears to be under way, we expect a tightening of the rules on what will constitute eligible collateral going forward. Credit institutions which currently rely heavily on the ECB for their funding requirements will need to take care to ensure that they can structure assets that will be compliant with future rule changes or be in a position to restructure existing deals to make them compliant.

8. The Financial Services Compensation Scheme and The Banking Act 2009 – dealing with the set-off risk



Set-off, in its various guises, can pose a significant structural risk in the context of securitisation transactions. In particular, a borrower can discharge debt owed ultimately to an issuer by setting-off any amounts owed to it by the originator. In securitisation transactions, where the predictability and certainty of cash-flows are key, identifying and countering this set-off risk is vital. This article considers the role played by the Financial Services Compensation Scheme ("FSCS") in mitigating such risk of set-off where the originator is a deposit taking UK bank, including the changes which will be effective from 31 December 2010. In the second half of this article, we discuss the Banking Act 2009 (the "Banking Act") and the extent to which it complements the FSCS in further mitigating the set-off risk for bank originators.

A recap of a few English law set off issues

We do not purport to set out the English law set-off analysis in full in this article. We would. however, like to summarise a few key points in the analysis of the current account set off risks under English law.

First, where the set-off right is available for a borrower (e.g. where such set-off right has not been excluded, or if excluded, is considered unenforceable), prior to the bankruptcy of the borrower and/or the insolvency, liquidation or administration of the originator, rights on the part of the borrower to set-off any amounts owing by it to the originator under the relevant assets may arise. Secondly, following liquidation/ administration of the originator or bankruptcy of the borrower, the insolvency set-off regime has no application to the relationship between the borrower and the securitisation vehicle (as assignee of the assets from the originator) and this relationship will be governed by the pre-insolvency set-off rules. Thirdly, following a liquidation/ administration of the originator, the insolvency set-off regime will not extinguish any legal or equitable rights of set-off between the borrower and the originator which accrued due prior to notice of assignment being given to the borrower and these set-off rights would remain available to the borrower against the securitisation vehicle as assignee of the assets.

We are aware that some rating agencies are of the view that there is a significant risk that a claim in respect of monies in a current account does not need to be due and payable in order to be "accrued due" for insolvency set-off; rather it is sufficient that the claim is in existence. Our opinion is that, in this situation, in respect of bank accounts of a borrower with the originator, only cross-claims comprising deposits for which the time for payment has fallen due and for which demand has been received by the originator prior to the giving of notice, are capable of being set off by the borrower against the securitisation vehicle in respect of the assets. In particular we consider that the case of *Joachimson* v *Swiss Bank Corporation* ([1921] 3 KB 110) is sufficiently analogous and persuasive in its analysis of the current account relationship, to provide a high level of support for our opinion.

For the purposes of this article, we will not go into further detail of the legal arguments around applicability of current account set-off and we will proceed from the starting point that the rating agencies consider there is a risk of current account set-off that needs to be addressed.

Does the FSCS mitigate set-off risk in the context of bank originator securitisation transactions?

The FSCS was established on 1 December 2001 under the Financial Services and Markets Act 2000 as a compensation fund of last resort for customers of authorised financial services firms. If the originator is unable to pay, or is likely to be unable to pay claims made by borrowers with respect to deposits[1] they have on deposit with the originator (the "Depositor"), a maximum compensation of £50,000 is available to them under the FSCS[2].

The FSCS is required to compensate any Depositor in respect of a protected deposit (which, for example, would include amounts standing to the credit of a current account), provided that the Depositor, in so far as it is able and required to do so, assigns the whole of its rights to the FSCS. As a consequence of such assignment of rights, the Depositor would give up any right of set-off. For deposits of £50,000 or less, this mechanism allows the FSCS to be an important mitigant against the set-off risk.

Some consideration of set-off still exists, however, because payments under the FSCS before 31 December 2010[3] are required to reflect the overall net claim

[1] An eligible depositor's £50,000 limit relates to the combined amount in accounts under all the 'umbrella' of a single banking licence.

[2] The FSA Compensation Sourcebook ("COMP") sets out the rules for the FSCS. For the FSCS to apply, there must be "eligible claimant" (COMP 4.2) with a "protected claim" (COMP 5.2) against a "relevant person" (COMP 6.2.1 R) who is in "default" (COMP 6.2.3R). All individuals are eligible compensation, but not all companies and partnerships.

against an originator (i.e. taking into account any rights of set-off that an originator would be able to exercise against the Depositor's claim). As a result, FSCS payments before and after 31 December 2010 would be calculated as follows:

- **Pre-31 December 2010 scenario**
  There will be deducted from any Depositor's compensation claim any sums owed by it to the originator with respect to non-securitised debt. As the Depositor could be entitled to uncompensated deposits equal to the amount of its non-securitised debt, they may not choose the FSCS route, choosing instead to set-off the whole amount.

- **Post-31 December 2010 scenario**
  Payments made to any Depositor pursuant to any compensation claim will be made on a gross basis and free from set-off. This will provide Depositors with an additional incentive to use the FSCS, and to not exercise their rights of set-off against the originator.

Liquidity in interim period

The FSCS is currently required to make any compensation payouts as soon as possible and in any case within three months of the satisfaction of the qualification conditions. In Policy Statement 09/11, the FSA announced that from 31 December 2010, requirements will be introduced whereby payments to Depositors will be made within seven days of determination of the default of the financial institution. There is a risk that during this short period, a Depositor may suspend making payments that fall due in respect of the securitised assets during this period. If notice of assignment has not yet been given then the Depositor will have existing rights of independent set-off. Although independent set-off is only a procedural defence and cannot be raised unless a claim is brought by the originator (or issuer), there is very little an originator can do if the Depositor does not hand over the money in those seven days. It is not very likely, for instance, that an originator or issuer would accelerate the loan (a self-help remedy not susceptible to procedural defences). Consequently, the timing and delivery of notice of assignment becomes an important factor in reducing the risk of set-off as opposed to the statutory regime.

FSCS and deposits greater than £50,000

It is arguable that the FSCS might not prove to be an effective mitigant of the set-off risk in respect of deposits which are greater than £50,000. This is because, to the extent deposits exceed the compensation limit, a Depositor may try to "recover" the full amount of its deposit by exercising its right of set-off. However, it is our view that even in these cases, a Depositor is likely to choose to elect the FSCS route due to its inherent advantage – it reinstates their short term accessible assets (the money in the current account) instead of getting relief from the long term liability of the loan (or indeed from a lengthy litigation process) – and only seeks to exercise set-off in respect of the excess over £50,000.

Do the Banking Act and the powers of the authorities under the Banking Act offer additional comfort/mitigants?

In light of the analysis above, it is our view that the FSCS will, certainly from the start of 2011, act as a full mitigant to any potential set-off risk in respect of deposits up to a balance of £50,000. In this section, we consider whether the Banking Act has any further mitigating effect on set-off risk, in particular for deposits of over £50,000.

Section 4 of the Banking Act sets out certain special resolution objectives, which include the following:

- protecting and enhancing the stability of the financial system of the United Kingdom (including, in particular, the continuity of banking services);
- protecting and enhancing public confidence in the stability of the banking system of the United Kingdom; and
- protecting depositors.

Ensuring that depositors have ready access to their investments (and thereby mitigating the risk of a run on the banks) is likely to be a major consideration for the authorities when they consider each of the objectives above. The code of practice published under sections 5 and 6 of the Banking Act (the "Code of Practice") specifically notes that continuity of banking services is relevant for the protection of depositors and that one aspect of public confidence in the stability of the banking system is the expectation that deposits will be repaid in accordance with their terms. The Code of Practice further notes that the protection of depositors can be achieved, for example, by facilitating fast payout to eligible depositors under the FSCS, arranging a bulk transfer of accounts through the bank insolvency procedure or facilitating continuity of banking services.

It would be difficult to argue that cancelling the accounts of the Depositors (on the basis that their rights under those accounts could be set-off against other debts owed to a originator) is conducive to the attainment of any of the above objectives – this could be contrary to the general public's legitimate expectation and

[3] See FSA Policy Statement 09/11 published on 24 July 2009. From 31 December 2010, compensation payments will be made on a gross basis.

is likely to be perceived as unfair. This is because the Depositor may, for example, have lost an instant access deposit in return for being in the less valuable position of having less long-term debt to pay – in other words, causing a forced refinancing of long-term debt (for example, a mortgage) in what is likely to be a difficult market with a higher cost for credit. Moreover, its application would depend on whether a depositor had chosen to maintain other banking relationships with the originator, thereby differentiating between customers and treating them differently, and, importantly, it may delay the return of deposits (since it will take some time to establish the net position).

The swift transfer of deposits to another institution is likely to offer depositors the greatest reassurance, and has the added benefit that they cannot then be subject to set-off. We note that the deposits of Bradford & Bingley plc were promptly transferred to Abbey National plc and the deposits of Dunfermline Building Society were promptly transferred to Nationwide Building Society when those institutions entered into the special resolution regime (and its antecedent regime under the Banking (Special Provisions) Act 2008).

In this regard, it is worth noting that certain aspects of the Banking Act, such as the capital market arrangement protection in The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009, contain carve-outs for deposits. This is a clear indication that the authorities do not want their powers in relation to deposits to be fettered in any way, leaving them with the greatest flexibility to transfer deposits out of a failing institution.

Following the application of the special resolution regime under the Banking Act, it is likely that certain assets (and liabilities) will be left behind in a "bad bank", although it appears unlikely on the basis of precedent that this would include retail deposits. This is clearly demonstrated by The Northern Rock plc Transfer Order 2009 in the context of the split of Northern Rock (effective from the beginning of this year) where all the retail deposits were transferred to the "good bank".

Where certain assets (and liabilities) are left behind in the "bad bank", the preferred insolvency procedure for the "bad bank" is bank administration. If deposits were to be left in a "bad bank" that entered bank administration, it would seem likely that they would be sold out as a valuable asset during the bank administration.

If an originator became insolvent before its deposits were transferred to a third party bank (which, arguably, would only happen in very limited circumstances), we note that the first objective of the bank insolvency procedure (which is specified in section 99 of the Banking Act and which does take precedence over the second objective) is to ensure as soon as reasonably practicable that each eligible depositor has the relevant account transferred to another financial institution or receives payment from, or on behalf of, the FSCS. In practice, we believe that this will mean that each Depositor will be protected in full from one or other stated sources – and not that a Depositor will be partially covered.

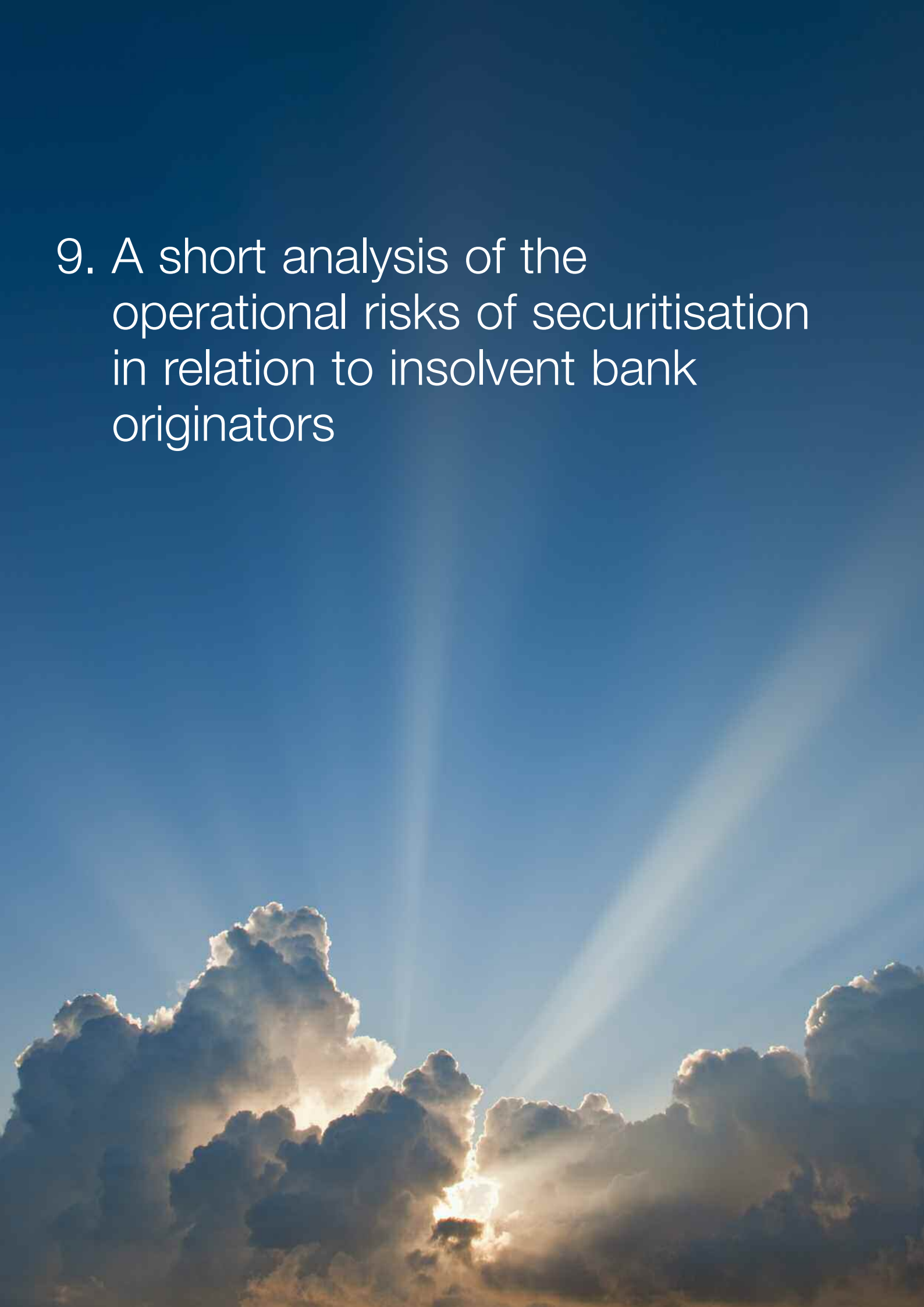
If deposits of over £50,000 were to remain on deposit with an insolvent originator and become subject to the rules on set-off, notwithstanding the discussion above, it is conceivable that (notwithstanding any purported set-off) a Depositor could become subject to a claim from or on behalf of a securitisation vehicle (of which they were previously unaware) for the full amount of any debt owed by it as the ability of the Depositor to set-off would most likely be contested. Such claims could lead to lengthy and complex litigation, which the authorities are bound to want to avoid and the Depositors would be uncertain as to their forward position in the meantime. It is also worth noting that neither the Depositor nor the originator is likely to have an incentive to argue for set-off to apply in these circumstances (since the Depositor would likely rather have access to their money in the current account and the originator would prefer that the full amount of any receivable remained outstanding as they would have access to excess cashflow and the full amount of any "seller share" in a securitisation).

In short, our answer to the present question as to whether the Banking Act provides further comfort or mitigation to the risk of set off above and beyond the FSCS, is that we would argue that it is highly improbable that the authorities would allow deposits to remain in an insolvent bank long enough to become subject to the uncertain application of the rules on set-off. Accordingly, although it is arguable that some set-off risks are legally present as a result of the Banking Act objectives and their application, the materialisation of risks is very unlikely.

Conclusion

In our view, many existing transactions currently carry too much enhancement for set-off risks in the light of the FSCS and Banking Act and the positive features of the Banking Act have not been fully assimilated in the market and particularly by rating agencies. We think there should be need for less enhancement for current account set-off risk in future transactions. On that we note Moody's paper entitled *Moody's Approach to Quantifying Set-off Risk for Securitisation and Covered Bonds Transactions Originated by UK Deposit-Taking Institutions* published in December 2009 and understand another agency has reached the same conclusion on specific transactions.

9. A short analysis of the operational risks of securitisation in relation to insolvent bank originators



Since the collapse of Lehman Brothers, rating agencies (and others including regulators) have put particular focus on the operational risks for a securitisation in the case of an originating bank insolvency, with particular focus on the "cliff risk" (i.e. originating bank overnight insolvency without being downgraded first). This has resulted in some recent transactions being penalised as a result of the perceived risks of the insolvency of the originating bank (e.g. that collections may be lost at the insolvent banks which, as a result, poses liquidity or credit risks for the securitisation).

In this article and the article entitled "The Financial Services Compensation Scheme and Banking Act 2009 – Dealing with the Set-Off Risks", we examine when these perceived risks occur (and indeed may be overstated) and how they can be mitigated under the documentation and in practice.

We assume, for the purpose of this article, that the structure in question is a "true sale" structure (i.e. not secured loans, originator trust or synthetic structure) and the originator is a UK bank.

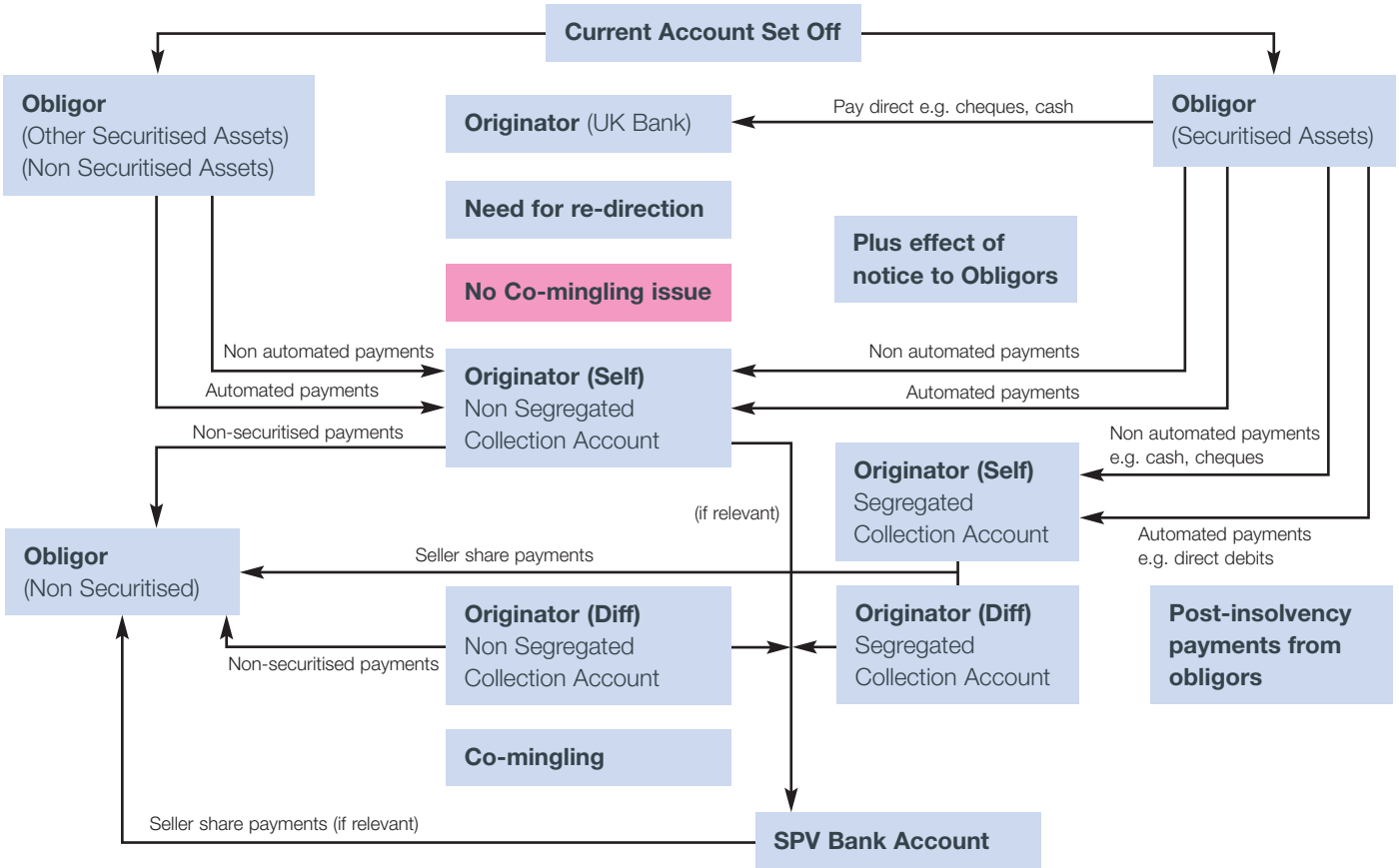
An indicative diagram

For the purposes of this article and in relation to the collections received from the underlying obligors, we assume two scenarios, scenario one being the originating bank holding the collections itself (both in relation to the securitised assets and non-securitised assets) and scenario two being the originating bank appointing a separate collection bank, which is a different legal entity to the originator, to hold the collections paid in by obligors (both in relation to the securitised assets and non-securitised assets).

The analysis of the different legal and operational risks from these two scenarios is shown in the diagram below.

Scenario one – originator as collection bank

As shown in the diagram, we do not think that there is a cash commingling issue in this scenario. This is because in reality all bank accounts are simply ledger entries



and there is no "physical" account with segregated or ring-fenced funds. It is trite law that a bank account is merely a claim – a chose in action – against the bank.

As there is no security over such account nor will these book-entries be ring-fenced or secured by other available assets, on the insolvency of the originator, the issuer will become an unsecured creditor of the originator and will not have any proprietary or security interest over the collections against the originator. In other words, in this situation, it would be correct for some rating agencies to point out that certain collections "credited" to the account and belonging to the securitisation would be "lost". However, what parties very often fail to analyse further is to what extent, and for how long, collections from obligors will be lost to the securitisation.

Collections received from the underlying obligors are usually allocated to customer accounts on a daily basis and the originator typically covenants, in the transaction documents, that it will transfer all collections in respect of the securitisation to the issuer on the same or next Business Day. This essentially means that, on the overnight insolvency of the originator, only the collections that have been paid to the originator but have not been transferred to the issuer as required under the transaction documents will be lost.

A common misconception is that all collections received post-insolvency of the originating bank will be lost. This is not correct. In practice, as soon as an insolvency official is appointed in respect of an insolvent financial institution such as a bank, he will notify the debtor's bank that no further payments should be debited to the debtor's existing bank accounts and that all receipts should, upon arrival in the existing account, be immediately transferred to a new account opened by the insolvency official. Where the insolvency official receives funds which he is informed that belong beneficially to another party, he's likely to set those funds on one side and not dissipate them pending clarification of the funds' status. It is unlikely that the insolvency official would immediately hand over the funds to the alleged 'true owner' until he has been satisfied on this score (which, as an aside, makes easy identification of securitised assets and collections important). Therefore, although there may be a time delay during which the insolvency official tries to establish the beneficial ownership of the funds, it would be incorrect to say that the insolvency official would somehow "snaffle" the funds and place them in the general insolvency estate of the originator and hence available to other creditors.

Typically in the securitisation documents we would expect to see provisions to the effect that upon originator insolvency and/or ratings downgrade, the person to whom the equitable title to the assets has been transferred – issuer on stand-alone transactions and mortgages/receivables trustee on master trust transactions – would be entitled to perfect the transfer of equitable assignment by serving notices to the underlying borrower, notifying them, *inter alia*, of the assignment of the portfolio by the originator or the issuer (or mortgages/receivables trustee) and that payments in respect of the underlying assets shall straightaway be made to an account of the issuer or the mortgages/receivables trustee instead of the originator. A power of attorney is also typically granted by the originator at the onset of the securitisation allowing the issuer (or mortgages/receivables trustee) to take any actions in the name of the originator. The expectation is that, upon insolvency of the originator, the issuer or the mortgages/receivables trustee would immediately open a collection account with a suitably rated third party bank into which all collections in respect of the securitisation will be paid into.

From a legal and operational perspective therefore, the key issue here is really one of re-direction, i.e. how quickly can such assignment and re-direction notice be put in place to practically "stop" the borrowers from continuing to make payments the originator and how effective would such a re-direction be. This, in many ways, depends on the payment methods of the underlying loans. In RMBS transactions, the majority of the payments by the borrower would be by way of direct debit. On other unsecured consumer assets securitisations, the payment methods will be more varied and may include direct debit, BACS, cheques, cash or debit card, by telephone by debit card and via internet. In practice, how best to re-direct payments from the borrowers under the different payment methods and the necessary lead time for effecting such re-direction are issues that are too detailed for this article but which we will elaborate on in further publications.

Regardless of how the re-direction is effected, in the context of an equitable assignment, it is established law that once each borrower has received an assignment notice and an instruction to discharge its payment obligations owing to the originator by paying into a different account, its set-off rights will be crystallised and it will no longer be able to

"A common misconception is that all collections received post-insolvency of the originating bank will be lost"

claim independent set-off against the originator (although this does not affect an independent set-off right which is "accrued due" or any equitable set-off right which may continue to exist), it will no longer be able to get good discharge of its debts by continuing to pay the originator to the existing collection account (*Re Pawson's Settlement, Higgins v. Pawson* [1917] 1 Ch 541) and if the borrower mistakenly continues to pay into the existing collection account after receiving the notice, the borrower would have to pay the amount due again into the new account designated in the notice.

In our view the risk of "loss" can be further mitigated for a couple of other reasons (so that the risks discussed in the preceding paragraphs, though relevant, are largely theoretical). First of all, the government has taken wide powers particularly through the Banking Act to ensure such a situation does not develop as shown in the Northern Rock collapse and nationalisation and transfer orders made in respect of Bradford & Bingley and the Dunfermline Building Society (as to which see the article entitled "*The Financial Services Compensation Scheme and Banking Act 2009 – Dealing with the Set Off Risks*". Secondly, in practice borrowers are unlikely to continue making payments to the originator after the insolvency of originator until the position is clarified which will allow time for notice and re-direction to occur without further loss.

Scenario two – third party holding collections

As shown in the diagram, in our view in this scenario (i.e. that the collection account bank holds the collections of the originator in respect of both securitised debt and non-securitised debt), a commingling risk would exist and associated with it, the risks of tracing. Both are discussed below. For a limited period of time (which, as mentioned above, is not expected to exceed one or two Business Days) that collections remain in the collection account of the originator, such monies may be commingled with other monies of the originator and may cease to be traceable if the account is operated and becomes overdrawn.

In a commingled collection account, although the collections in respect of the securitised assets are beneficially owned by the Issuer, there is a risk that in the event of the insolvency of the originator, any monies in the collection account which are beneficially owned by the Issuer would be held up in the insolvency proceedings of the originator which might prevent the Issuer from obtaining those monies on a timely basis from the originator. As a result of this risk, in an English securitisation transaction it is customary for the originator to enter into a declaration of trust over the monies standing to the credit of the collection account which creates a trust over all the monies collected in favour of the issuer in respect of assets beneficially owned by the issuer (and in favour of itself over the monies collected in respect of the non-securitised assets). The existence of this trust is typically notified to the collection account bank.

The effect of the Issuer's beneficial interest in the trust created by the originator will be that, in the event of the insolvency of the originator, it will immediately be clear to the account bank that such monies will not fall within the bankruptcy estate of the originator and the trustee of securitisation can demonstrate to the liquidator or administrator of the originator that such monies beneficially owned by issuer should be paid directly to the issuer without waiting for any insolvency proceedings in respect of the originator to be partially or fully concluded. Provided that the declaration of trust satisfies the required legal tests for a validly constituted trust, it would not be difficult for the trustee to demonstrate that monies beneficially owned by the issuer shall be paid directly to the issuer and for the account bank to accept this.

It is important to distinguish case law relating to where a trustee and a beneficiary lawfully mix trust and non-trust funds of a trustee (in this case it would be the originating bank) in an account, the trust money is used by the trustee and becomes the trustees', subject only to a personal obligation to repay. Consequently the "beneficiaries" under the trust have no interest in the trust assets and are ranked as unsecured creditors of the trustee (*Space Investments Limited v Canadian Imperial Issuer of Commerce Trust Co (Bahamas) Limited* [1986] 1 W.L.R 1072).

In our view this case relates to situations where the beneficiary expressly allows the trustee to use the monies for its own purposes. This is different in securitisations when the declaration of trust would normally contain restrictions on the originator's ability to withdraw trust monies belonging to the beneficiaries from the collection account. These restrictions would typically include, for instance, that the originator may only make withdrawals from the collection account in accordance with the servicing agreement in the amounts to which the originator is entitled pursuant to the declaration of trust.

If these restrictions are complied with, *Space Investments* (supra) is distinguished on the basis that the beneficiary in that case had expressly allowed the trustee, under the trust instrument, to generally appropriate trust money to another account where it could be used for its own purposes.

Where the tracing remedy is available, it can be applied against a mixed fund in a bank account to the extent that the trust funds can still be shown to be there. It should be noted that if the account falls below that sum, that part of the trust money is deemed to have been spent (*Roscoe v Winder* [1915] 1 Ch.62). Accordingly, the issuer would only ever be able to recover money from the collection account relating to the securitisation to the extent that it is actually there. Where an account is in overdraft, tracing cannot be used by a beneficiary (re *Diplock* [1948] CH 456 and *re Goldcorp Exchange Ltd* [1995] 1AC 74), since one cannot trace through a non-existent fund.

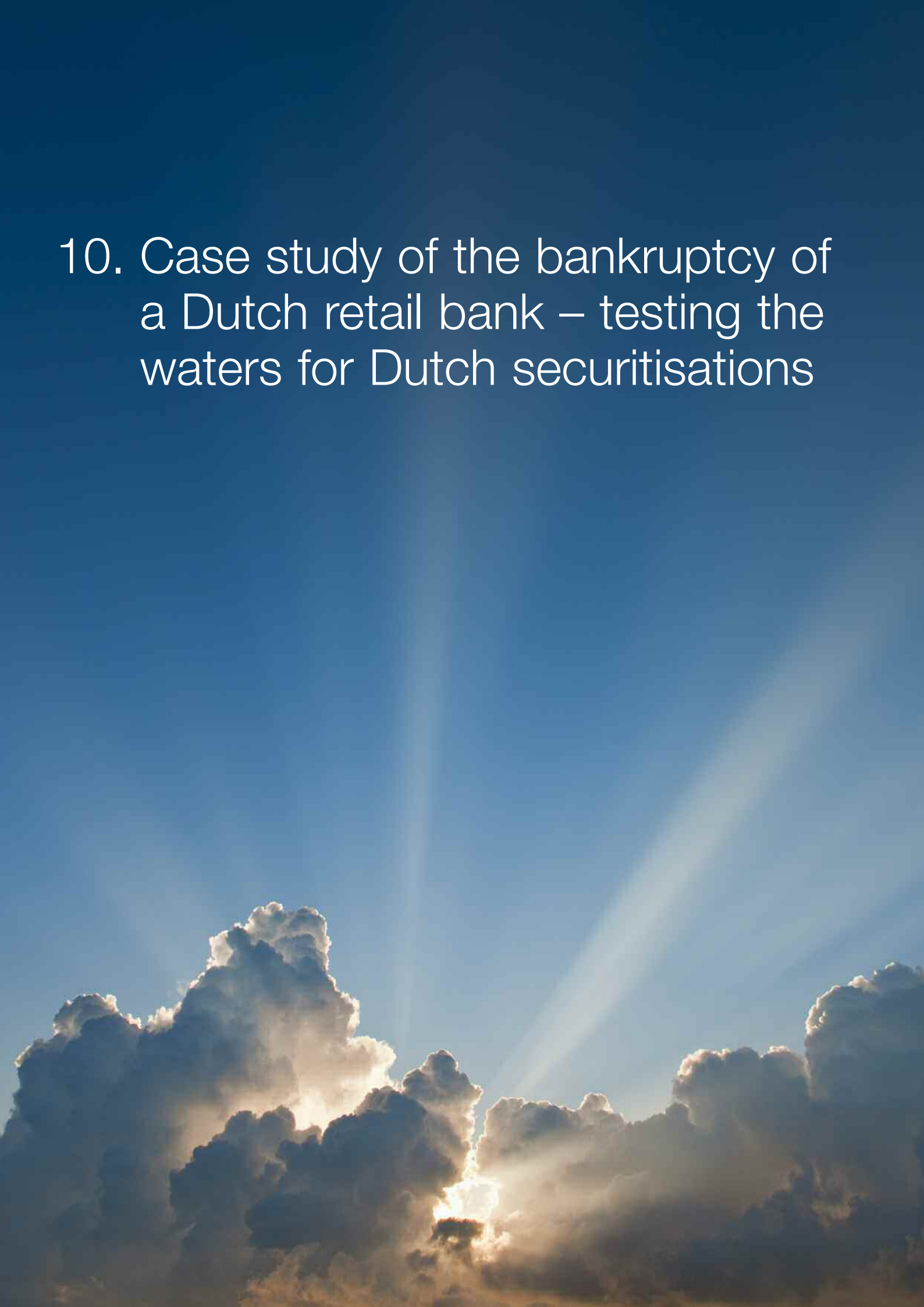
In the same way as under scenario one, once the originator is insolvent, notices will be sent to the borrowers re-directing them to make payments to an account of the issuer (or mortgages trustee or receivables trustee on master trusts). The re-direction process and effectiveness would be broadly similar to scenario one. While this is strictly not necessary as result of the continuation of the trust, it would make administration of collections easier not least as involvement of an insolvency officer would be removed but also because a replacement servicer is likely to wish to have its own arrangements established.

We would also stress that, in our view, although in scenario two the declaration of trust by the originator coupled with the restrictions on the ability of the originator to deal with the collections – if complied with in practice - is capable of mitigating the commingling and tracing risks, there is no real benefit for such declaration of trust in scenario one. As mentioned above, in scenario one, there will be no cash in a physical collection account (other than book entries) and a trust declared over it would, in reality, be over the originator's chose in action which does not create any valuable proprietary interest for the benefit of the issuer as the claim will be against an insolvent originator. As mentioned above, the real mitigant in scenario one therefore lies in the speed with which the re-direction process can be carried out.

Conclusion

In our view, the operational risk on securitisations in the context of originating bank insolvency is an area that requires more focus. In this respect, sequencing of issues is important for analysis, both pre-insolvency, at the point of insolvency and during insolvency. We also believe that the practical impact of the Banking Act needs greater assimilation. Nevertheless, it is clear that the whole area of operational risk on bank securitisations will continue to be the focus of rating agencies and regulators. We are conducting more detailed analysis in relation to these issues and will share that with the market when available.

10. Case study of the bankruptcy of a Dutch retail bank – testing the waters for Dutch securitisations



Although there have been a number of banks in the Netherlands that have become subject to bankruptcy proceedings, until recently this did not involve banks that had securitised large parts of their assets. In October 2009, however, DSB Bank N.V. ("DSB"), a Dutch retail bank that had securitised large parts of its residential mortgage loan and consumer credit loan portfolios (under the names Chapel, Convent, Dome and Monastery) became subject to bankruptcy. This article focuses on the impact so far of DSB's bankruptcy on its securitisations. Our observations are based on publicly available information, including press articles, relevant public offering documentation and published bankruptcy reports up to the middle of May 2010.

History and bankruptcy of DSB

DSB's history goes back to 1975. It has mainly been active as a consumer credit and mortgage loan provider and as a consumer credit, mortgage loan and insurance intermediary. It obtained a Dutch banking licence in 2005 after which it further broadened its retail banking operations. DSB's shares are all held by the holding company of DSB's founder, Mr. Scheringa. Mr. Scheringa's holding company – which was declared bankrupt shortly after DSB's bankruptcy – also holds shares in a number of other companies with various business activities, including the insurance business. Mr. Scheringa was also chief executive officer of DSB.

In the months prior to its bankruptcy, DSB had been criticised in the media for its sales methods in respect of loans and related savings and insurance products. This criticism primarily focused on alleged breaches of a duty of care by DSB towards its customers, in particular in relation to over-crediting of customers and lack of transparency of costs relating to its insurance products. A number of groups holding themselves out as representatives of aggrieved DSB customers voiced concerns. In early October 2009 it appeared that whilst one group was close to a settlement arrangement with DSB on behalf of the DSB customers it represented, one other group publicly confirmed that it no longer wished to participate in settlement discussions with DSB and – through its representative – publicly hinted that DSB customers may have gotten a better deal if DSB became subject to bankruptcy proceedings and settlement discussions were held with its bankruptcy receivers. It therefore advised customers to withdraw their deposits.

The Dutch government has ordered an investigation into the circumstances and facts which led to DSB's bankruptcy the results of which are not yet published. However, it is widely believed that a combination of DSB's alleged aggressive sales methods and the advice to withdraw deposits resulting in public attention in respect of DSB's capital and liquidity position as well as rumours that the Dutch Central Bank was taking action to declare emergency regulations (*noodregeling*) pursuant to the Dutch Financial Supervision Act (*Wet op het financieel toezicht*) in respect of DSB, led to a run on the bank. A number of rescue operations were proposed in the short time available, which would have involved the potential participation by other Dutch banks, but they were unsuccessful. The Dutch Central Bank therefore requested the application of emergency regulations in respect of DSB. The Dutch Central Bank was of the view that the solvency and liquidity position of DSB showed signs of a dangerous trend with no reasonable prospect of improvement, which is one of the tests for which a Dutch court can subject a bank to emergency regulations.

Whilst the court confirmed in its ruling of 11 October 2009 that DSB's liquidity position was very disturbing, it initially rejected such request. However, the publicity and rumours surrounding the proceedings resulted in a further decrease of DSB's solvency and liquidity position. This resulted in an immediate second request by the Dutch Central Bank for application of emergency regulations. The court declared such emergency regulations on 12 October 2009.

A few days later the court-appointed receivers requested that the court convert the emergency regulations into bankruptcy proceedings on the basis of DSB's negative equity position and because there was no prospect of a continuation of DSB as a going concern. The court, however, allowed Mr. Scheringa and the receivers a limited period of time to investigate whether there could be ways to avoid bankruptcy. No satisfactory solution was found and DSB was declared bankrupt on 19 October 2009. As a consequence of DSB's bankruptcy its banking licence was revoked. However, also taking into account DSB's continuing servicing of securitised and unsecuritised loan portfolios, activities which require a licence under the Dutch Financial Supervision Act, DSB is nevertheless regarded as a licensed bank during the process of liquidation.

At the time of its bankruptcy, DSB had a number of outstanding securitisations. Its

most recent public (but retained) securitisation closed in April 2009.

Without purporting to be complete, we will now describe in the below paragraphs the impact that DSB's bankruptcy has had on various matters (including assignment notification, servicing, interest rate resets, set-off and swap terminations) which are integral to the structuring and rating of a Dutch securitisation.

Impact of DSB's bankruptcy on DSB securitisations

Notification of assignment

The majority of DSB's securitised loan receivables have been transferred to a typical securitisation special purpose vehicle ("SPV") by way of silent assignment, which is a common transfer method used in Dutch securitisations. As a consequence of silent assignment, as long as no notification has taken place, any payments made by the debtors under the transferred receivables must continue to be made to DSB. In respect of payments so made prior to DSB's bankruptcy taking effect, the SPV will be an ordinary, non-preferred creditor. In respect of post-bankruptcy payments, the SPV will be a creditor of DSB's estate, and will in principle receive payment prior to creditors with bankruptcy claims, but after preferred creditors of the estate.

As is customary in Dutch securitisations, the application of emergency regulations, moratorium of payments or bankruptcy of an originator constitutes an assignment notification event. Upon the occurrence of such event, the SPV and/or security trustee may notify the borrowers of the assignment of the receivables to the SPV unless the rating agencies confirm that not giving such notification will not result in rating downgrades of the notes issued in the securitisation. The consequence of such notification would typically be that the principal and income proceeds of the receivables are segregated from the originator and are directly paid by the borrowers into transaction accounts of the SPV or security trustee.

"DSB had been criticised in the media for its sales methods in respect of loans and related savings and insurance products"

Prior to 2004, under Dutch law a transfer by way of silent assignment was not possible. In the DSB securitisations until 2004, a conditional assignment structure was used, meaning that the transfer of receivables would not be perfected until notification of the assignment is given to the debtors, to avoid that debtors would have to be notified at inception. To address that such assignment may not be validly perfected upon insolvency the receivables have amongst other things been pledged to the relevant SPV by way of an undisclosed pledge as security for DSB's obligations under the relevant transaction documents. In this section we will only focus on securitisations involving silent assignment of receivables albeit that the analysis is more or less similar for transactions involving silent pledges.

Although DSB was subject to emergency regulations and is now subject to bankruptcy, notification of the assignment of receivables to the various SPVs has not been given to the borrowers. Therefore borrowers can only discharge their debts by making payments directly to DSB. The fact that no such notification has been given results from arrangements that have been made between DSB's receivers and the various SPVs and security trustees to the effect that such receivables proceeds are on-paid by the receivers to the SPVs.

Such arrangements may have been put in place to address concerns that such customers would suspend payments in respect of both securitised and unsecuritised receivables upon such notification, since such customers may fear that any damages claims (or parts thereof) that they may have in connection with alleged misselling claims might remain unpaid in DSB's bankruptcy. Another reason for the receivers agreeing to such arrangements may have been that DSB is likely to be holding subordinated or other first loss positions in one or more of its securitisations as a result of which non-payment by customers may ultimately have a negative effect on DSB's estate. The perception that maintaining DSB as existing servicer would reduce payment suspensions or losses is supported by the fact that in the first month after DSB's bankruptcy ninety per cent. of the borrowers had continued their monthly payments and more than fifty per cent. had given new direct debit instructions.

It therefore follows that events that constitute assignment notification events under securitisations may not immediately result in actual notification to borrowers of the assignment, in particular if it is believed that such notification is likely to result in cashflow disruptions. However, in circumstances where receivers would not have been willing to on-pay future receivables

cashflows, notification may have been the only appropriate remedy to protect such cashflows.

Servicing of receivables

One would typically expect servicing agreements in securitisations to include provisions allowing the SPV and/or security trustee to terminate the servicing arrangements early with the initial servicer in the event of default on the part of such servicer, including its bankruptcy.

In the DSB securitisations, servicing of securitised and unsecuritised loans continues to be performed by DSB. Therefore, further arrangements have been made by the receivers with the various SPVs and security trustees with respect to the continuation of servicing activities as otherwise it could be expected that such initial servicing arrangements would have been terminated early as a result of DSB's bankruptcy. We understand that the receivers are currently investigating a re-launch of DSB's servicing business unit in a strategic co-operation, if necessary, with a reputable third party in order to continue further stabilising loan servicing and creating a separate servicing platform.

In particular in respect of more recent securitisations, it would also be common for such transactions to include back-up servicing arrangements, such as covenants for the relevant parties to appoint back-up servicers upon termination of the initial servicing arrangements or the appointment of a back-up servicer on the initial closing date of the transaction which appointment is conditional upon certain events occurring in respect of the initial servicer.

"The perception that maintaining DSB as existing servicer would reduce payment suspensions or losses is supported by the fact that in the first month after DSB's bankruptcy ninety per cent. of the borrowers had continued their monthly payments and more than fifty per cent. had given new direct debit instructions"

We understand that back-up servicers have only been appointed with respect to some, but not all, of DSB's securitisations or are in the process of being appointed. The reason for not appointing back-up servicers on a large scale on the DSB securitisations may very well be that there is no immediate necessity for such appointment, taking into account the receivables proceeds distribution and servicing arrangements made between the receivers on the one hand and the SPVs and security trustees on the other. It might also imply that from an operational perspective (for example, due to IT incompatibility and/or reporting systems, use of differing servicing manuals, data protection issues or otherwise) it may not be straightforward for third party servicers to replace existing servicers. We have seen in other unrelated securitisations that it can be difficult to find third party servicers for reasons set out above or due to the fact that there are only a handful of parties that are eligible, capable or interested in taking on such roles.

In their most recent bankruptcy report, the receivers indicated that from an efficiency and continuity perspective, they wish to appoint a single back-up servicer for all securitised and unsecuritised portfolios. The report also states that none of the parties which are currently involved has expressed a willingness to take on the back-up servicing role for the entire portfolio.

It follows that, notwithstanding that the relevant initial servicing arrangements may allow for early termination remedies, at least for the initial period following DSB's bankruptcy, DSB continuing its servicing activities reduces the risk of cashflow disruptions.

Interest rate reset rights

Dutch mortgage loans traditionally have a maturity of 30 years whilst the interest thereon is either based on a variable rate or a fixed rate. The borrower may usually opt to set the interest rate for shorter periods (e.g. 5, 10, 15 or 20 years) than the maturity of the mortgage loan. As a result, the interest rate is to be reset at the end of the relevant period. It is uncertain under Dutch law whether an interest reset right (as an ancillary right) will transfer to the transferee upon the assignment of the relevant (loan) receivable to the transferee. If in a securitisation such interest reset right would not transfer to the SPV and would not terminate automatically as a result of such transfer, it would probably remain with the transferor (in this case, DSB) meaning that the co-operation of the receivers would be required to reset such interest rates. This is usually a concern for rating agencies and third

party swap providers given that, in circumstances where there would be an incentive for the receivers to reset the rates below market level, this could result in losses for investors on the notes or the swap providers. Such losses are usually not taken into account when structuring the transaction and/or entering into the relevant swap agreement.

Whilst we believe that there are good arguments for the related interest rate reset right to follow a receivable upon its transfer, we also believe that where such right does not follow, a receiver who would, contrary to the instructions of the SPV (where such instructions would typically be at the discretion of the SPV but subject to the terms and conditions of the loan contracts), set the interest rates below market levels without there being a valid reason to do so, would expose himself to personal liability in respect of the SPV and other interested parties on the basis of contractual breach or tort. We would therefore expect receivers to act in a commercially reasonable and prudent manner in such matters.

The servicing arrangements for the various DSB securitisations are expected to provide that the originator as initial servicer is responsible for setting the interest rates from time to time in respect of the securitised loans although it cannot be excluded that third party swap providers involved in a securitisation may have certain rights under the documentation to stipulate minimum interest rates. We assume that, as part of the agreed receivables proceeds distribution and servicing arrangements, DSB will continue to reset the interest rates for so long as it remains the servicer of the securitised receivables.

"The receivers indicated that from an efficiency and continuity perspective, they wish to appoint a single back-up servicer for all securitised and unsecuritised portfolios"

Set-off rights of borrowers

Notwithstanding the assignment and pledge of receivables to the various SPVs and security trustees, respectively, the borrowers may be entitled to set-off the relevant receivable against a claim they may have vis-à-vis DSB (if any), such as counterclaims resulting from a current account relationship and, depending on the circumstances, counterclaims resulting from a deposit made by a borrower. In the absence of contractual provisions expanding statutory set-off possibilities, mutuality of claims is one of the requirements for set-off to be allowed: the parties, mutually, must be each other's creditor and debtor. Following an assignment of a receivable by DSB to the relevant SPV, DSB would no longer be the creditor of the receivable. However, so long as the assignment of the receivable by DSB to the relevant SPV has not been notified to the relevant borrower, the borrower remains entitled to set-off the receivable as if no assignment had taken place.

After notification of the assignment or pledge, the relevant borrower can still invoke set-off pursuant to the relevant provisions of the Dutch Civil Code (*Burgerlijk Wetboek*). On the basis of such provisions a borrower can invoke set-off against the relevant SPV as assignee (and the relevant security trustee as pledgee) if the borrower's claim vis-à-vis DSB (if any) stems from the same legal relationship as the receivable or became due and payable before the notification. Furthermore, it is possible that (on the basis of an analogous interpretation of such provisions) a borrower will be entitled to invoke set-off rights against the SPV if prior to the notification, the borrower was either entitled to invoke set-off rights against DSB (for example, on the basis of the Dutch Bankruptcy Act) or had a justified expectation that he would be entitled to such set-off against DSB. Where any mortgage loan origination documentation of DSB would provide for a waiver by the borrower of his rights of set-off vis-à-vis DSB, such waiver could be avoided pursuant to Dutch contract law and may therefore not be enforceable.

In relation to DSB's bankruptcy it is likely that set-off questions will arise in connection with amongst other things (a) claims of borrowers under savings deposits and the provisions of the Dutch deposit-guarantee scheme (which is based on European Directive 94/19/EC on Deposit Guarantee Schemes) and (b) any potential claims for damages by borrowers in relation to alleged breaches of duty of care by DSB.

As regards (a), certain deposits held by customers with DSB were covered by the Dutch deposit-guarantee scheme. The Dutch Financial Supervision Act and its relevant subordinated regulations and decrees are based on the presumption that deposit amounts held by customers with the insolvent bank will be set-off against any amount owed to such bank by its customers

(under loans or otherwise). However, we understand that no such set-off has been applied in DSB's bankruptcy and that payments have been made by the Dutch Central Bank to customers up to a maximum amount of EUR 100,000 per customer (as currently prescribed by the Dutch deposit-guarantee system regulations).

As regards (b), if such claims for damages prove to be successful (either on the basis of court judgment or settlement arrangements with the receivers) borrowers would be entitled to invoke set-off in respect of such claims against amounts owed by them under the relevant loans (whether or not securitised). We understand that certain customers have expressed their intention to set-off such claims for damages and that the receivers have informed such customers that if it is established that DSB has breached its duty of care towards such customers and such customers have resulting claims for damages, the receivers will take this into account in order to decrease the debts owed by such customers to DSB.

If set-off is applied this may have a negative impact on the SPVs (and their noteholders and other creditors) in circumstances where DSB's bankrupt estate would not be sufficient to reimburse the SPVs for amounts so set-off since the SPVs will be ordinary creditors for such reimbursement amounts. If set-off is not applied, for example, because actual pay-outs are made to customers under the Dutch deposit-guarantee scheme, this may have a positive impact for the SPVs since in respect of their claims against DSB for proceeds received, the SPVs will be creditors of the bankrupt estate and will therefore have a preferred position as regards ordinary creditors. Obviously, the application of set-off would have a positive impact on the position of the participating banks in the Dutch deposit-guarantee scheme as their mandatory payment contributions under the Dutch deposit-guarantee scheme would decrease as a result of such set-off.

More generally, taking into account the negative impact that the failure to apply set-off may have on banks participating in the Dutch deposit-guarantee system (and the positive impact this may have for SPVs) and the fact that set-off risk is commonly disclosed and mitigated through credit enhancement features in securitisations, it would not be surprising if in the future Dutch banks were to take the initiative in lobbying for legislative reforms in this regard.

Swap transactions

As is common in securitisations where income of securitised assets and other assets of the SPV fluctuate or do not match the fluctuating interest rate obligations of the SPVs, swap transactions were entered into under the various DSB securitisations.

Since DSB did not have an official credit rating, it was not eligible to act as swap provider on its securitisations. We understand that third party swap providers with the minimum required credit ratings entered into front swaps with the SPVs in DSB's securitisations and that such swap providers in turn entered into back to back swaps with DSB to ensure that the economic benefits and risks relating to interest rate mismatches of the SPVs' assets and liabilities were transferred to DSB. We also understand that all such back to back swaps were terminated early as a result of DSB's bankruptcy. In principle, the early termination of the back to back swaps did not impact on the front swaps.

As was the case in the securitisation markets generally, securitisation basis rate swaps and in particular the back to back swaps and related collateral arrangements – are somewhat bespoke. This may have made it difficult for such swap providers to obtain and/or determine replacement values or to determine their losses. It remains to be seen whether any such determinations, valuations and/or any early termination payments claimed from DSB by "in-the-money" swap providers will be challenged by the receivers. In this respect, one of the bankruptcy reports states that the receivers will consult with the swap providers in relation to relevant determinations and valuations which indicates that the receivers are not necessarily in agreement with such determinations and valuations.

Impact of DSB's bankruptcy on rated DSB securitisations

As far as we are aware, DSB's bankruptcy did not impact the credit ratings assigned by Standard & Poors to notes issued by the various SPVs in DSB's securitisations. However, within a

"If set-off is applied this may have a negative impact on the SPVs (and their noteholders and other creditors) in circumstances where DSB's bankrupt estate would not be sufficient to reimburse the SPVs for amounts set-off"

month of DSB's bankruptcy, Moody's downgraded the notes in the various Chapel and Monastery securitisations by two notches from AAA to Aa2. In addition, in March 2010 Moody's put the notes rated by it on negative outlook and downgraded the various subordinated notes in these securitisations with a then current rating of high B to a low B and subordinated notes with a then current rating of low B to a high C. We understand that the main reasons for such downgrades were fears of cashflow disruptions caused by borrower defaults resulting in portfolio losses, and that noteholders would not be informed in a timely manner in respect of any such disruptions.

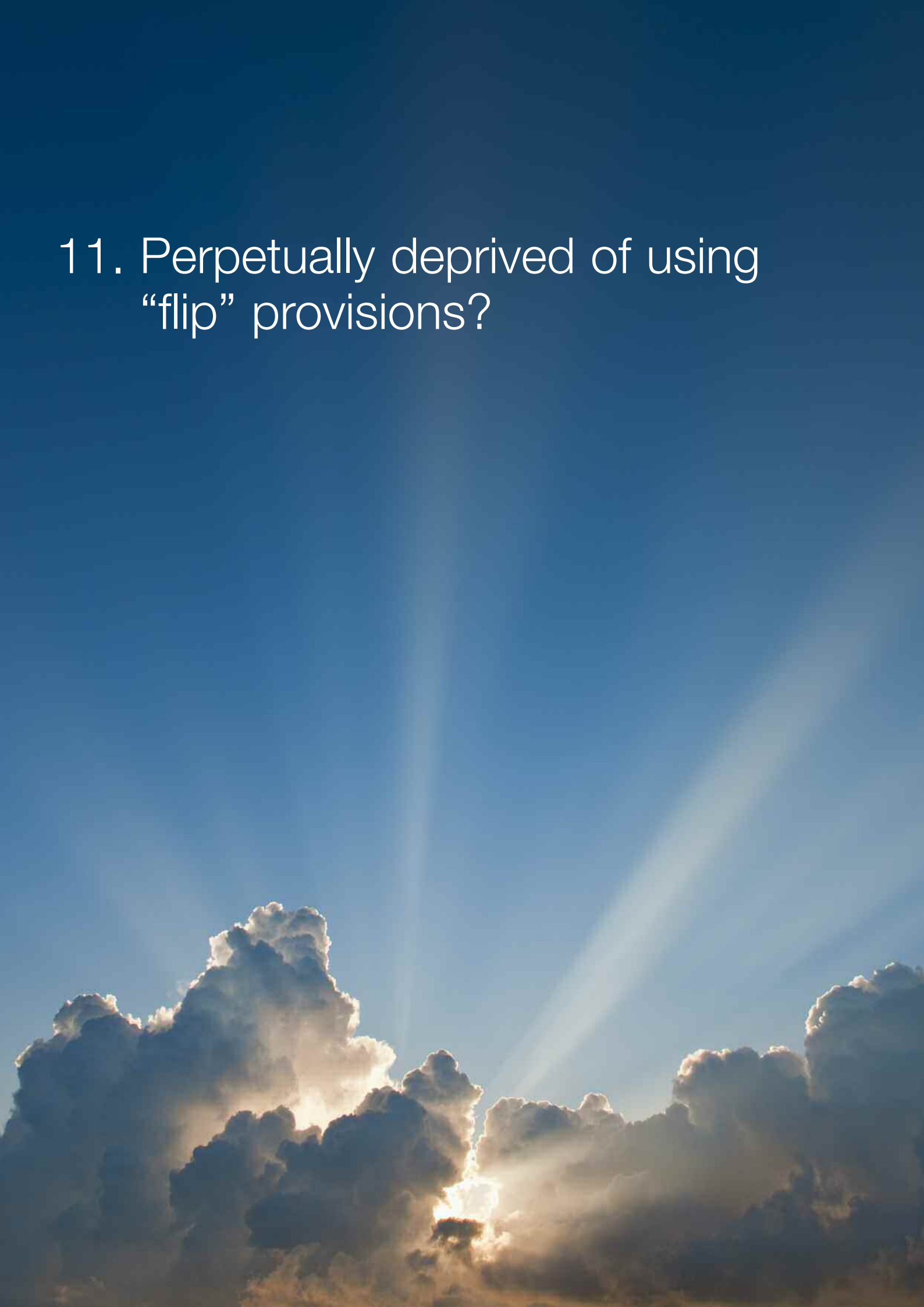
Conclusion

Whilst it is expected that DSB's bankruptcy will continue for at least a couple of years and therefore the position of participants in DSB's securitisations, including SPVs, may in many respects be uncertain, so far it appears that not all of the risks and events that market participants and rating agencies would typically expect have materialised when structuring and rating a Dutch securitisation. It has also become clear in the case of DSB that, where the transaction documentation would typically provide for certain contractual remedies in the case of certain insolvency related events relating to an originator or servicer, such remedies are not necessarily immediately pursued by the SPVs and security trustees.

The reasons for this may very well be that where an originator has unsecuritised portfolios or subordinated securitised positions on its balance sheet, the interests of the receivers may initially be aligned with those of the SPVs and security trustees. By avoiding confusion and misunderstandings by borrowers, cashflow disruptions are, at least in the period immediately following the imposition of bankruptcy proceedings, expected to be minimised. Such confusion and misunderstandings can be avoided by sending clear messages to customers and, particularly in respect of borrowers whose loans have been securitised in different transactions, by having one single customer facing contact servicing the loans.

Nevertheless, it remains to be seen to what extent any application of set-off by borrowers may have an impact on the SPVs and security trustees, also bearing in mind that, should any damages claims for duty of care breaches prove to be successful, the SPVs and security trustees will have limited protection measures available to minimise losses on the securitised portfolios. This is due to the fact that any triggered indemnity or reimbursement obligations of DSB under the securitisations will be of little or no value to the SPVs and security trustees where DSB's bankrupt estate would be insufficient to meet such claims of the SPVs and security trustees as ordinary creditors. Third party investors in DSB's securitisations will need to continue to hope that any such potential losses will not exceed any retained positions held by DSB.

11. Perpetually deprived of using “flip” provisions?



At the time our last article on this topic, "*OTC Derivatives in structured debt transactions*" was published as part of our New Beginnings publication, the Court of Appeal judgment in the *Perpetual Trustee Company Limited v BNY Corporate Trustee Services* [2009] EWCA Civ 1160 case had just been handed down and the rating agencies had initially reacted by requiring legal opinions to address specifically the enforceability of priority of payment provisions in securitisation transactions. We had gazed into our crystal ball and speculated on how the pending decision of the US Bankruptcy Court on the same issue might result in US swap counterparties being excluded from the market in Europe, unless acting through locally incorporated subsidiaries.

This aim of this article is to provide an overview of the current state of the *Perpetual* litigation, to consider the rating agencies' reactions and to describe some of the solutions and market developments resulting from the litigation.

Perpetual – where are we now?

The *Perpetual* case concerned a Delaware incorporated Lehman entity ("LBSF") which entered into a swap with a special purpose issuer of notes under which LBSF paid sums equivalent to the sums payable by the issuer to the noteholders under the notes in exchange for sums equal to the yield on the collateral purchased with the subscription moneys from the notes and held by the issuer. Payments due from the issuer were secured in favour of the noteholders and LBSF (amongst others) and subject to a priority of payment waterfall which entitled LBSF to receive payment ahead of the noteholders prior to the occurrence of an event of default in respect of LBSF (which included related insolvency events), but following an event of default ranking LBSF behind the noteholders. This change in the priorities is colloquially referred to as the "flip provision". Following the collapse of the Lehman Group, payments due to the noteholders were not made and Perpetual Trustee, as noteholder, issued claims against BNY Corporate Trustee Services Limited (the "Security Trustee"), seeking orders that the Security Trustee procure the realisation of the collateral held as security in Perpetual's favour and in priority to the claims of LBSF under the swap.

As discussed in more detail in our previous article, all three English Court of Appeal Judges declined to apply the anti-deprivation principle to the facts. However, they differed on the basis on which they did so. The variance was due to Patten LJ's preparedness to exclude secured waterfall arrangements entirely from the scope of the principle, as opposed to the reasoning of Lord Neuberger MR and Longmore LJ, who decided that the application of the anti-deprivation principle should be decided on a case by case basis. With regard to why he chose to diverge from Patten LJ's assessment, Lord Neuberger MR rather confusingly says "*while that view [of Patten LJ] may well indeed be right, I prefer to rest my conclusion in this case on the more limited ground that in addition to the facts relied on by Patten LJ the assets over which the charge exists were acquired with money provided by the chargee in whose favour the flip operates, and that the flip was included merely to ensure … that the chargee is repaid out of those assets all that he provided (together with interest) before the company receives any money from those assets pursuant to its charge*"[1]. This reasoning of Lord Neuberger MR has complicated the way in which the anti-deprivation principle is addressed in legal opinions and in prospectus risk factors.

In England, leave to appeal the decision of the Court of Appeal was granted on 26 March 2010 and the English Supreme Court is expected to hear the case during spring 2011.

In the US, Judge Peck published his statement of the law on 25 January 2010, which was "*directly at odds with the judgment of the English Courts*"[2]. Judge Peck found that the flip provision did in fact contravene the ipso facto provisions of the US Bankruptcy Code. In reaching this conclusion, Judge Peck gave a broad interpretation to the relevant provisions, finding that they applied to any provision which purported to vary contractual rights on the commencement of any bankruptcy case under Chapter 11, not merely a bankruptcy case involving the insolvent swap counterparty. While Judge Peck acknowledged that there would need to be some connection between the case commenced under Chapter 11 and the parties in question, he held that the commencement of a case under Chapter 11 in respect of LBSF's parent entity was a sufficiently close

[1] See paragraph 67 of the Court of Appeal judgment [2009] EWCA Civ 1160

[2] See page 15 of the *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd.*, Ch. 11 Case No. 08-13555. Adv. No. 09-01242 (Jan. 25, 2010).

connection. As a result of this, it did not matter whether the flip provision was triggered prior to the onset of insolvency in respect of LBSF; it still contravened the ipso facto provision. In either case, the flip took effect upon the commencement of a case under Chapter 11 and was thus unenforceable. Judge Peck also found that the flip provision did not form part of the swap agreement itself, and therefore could not be protected by the 'safe harbour' provisions of the US Bankruptcy Code which permit the termination of various derivative contracts notwithstanding the commencement of Chapter 11 proceedings. However, this decision has still not been memorialised and so is technically not a court judgement. This is a feature of the US court system, which observers may find slightly odd, particularly as no application for appeal against the decision evidenced in Judge Peck's statement can be made until the judgment is memorialised.

Recently two motions have been filed, one of which has been granted, which will impact the course of the *Perpetual* litigation in the US. First, on 22 April 2010, the court granted the motion filed by certain Lehman entities in the US Bankruptcy Court for permission to purchase, without further court approval, notes (or participations in notes) issued by special purpose issuers which have one of the relevant US Lehman entities (including LBSF) as a counterparty. The *Perpetual* litigation was referred to in the motion and the implication of this motion is that Lehman will seek to purchase the notes in the Perpetual case in an attempt to halt the litigation. Second, in May 2010, BNY Corporate Trustee Services Limited ("BNY") requested that the US Bankruptcy court enter an order in respect of Judge Peck's previous statement of law. BNY noted the Bankruptcy Court's desire to coordinate the US Decision with the ruling of the English courts regarding litigation between LBSF and Perpetual (the sole noteholder in the transaction). However, BNY asserted that as it has been more than three months since the Court issued its decision the Court should enter an order memorializing the US Decision so that the "*inevitable and lengthy U.S. appellate process can at least begin*" so that any later coordination reflects the "*confirmed judgment of the courts at all levels of the two jurisdictions*." In the alternative, BNY requested that the Court grant reargument of the parties' cross-motions for summary judgment and enter a declaratory judgment in BNY's favour or, as warranted, order targeted discovery and an evidentiary hearing to resolve the case. In a recent status conference Judge Peck asked the parties to agree a date falling after 16 June 2010 on which to hold the hearing.

"The rating agencies' response was viewed by many market participants as an over-reaction"

Rating agency reaction to the litigation in the US

There has been much market commentary on the merits of Judge Peck's decision from a US Bankruptcy law perspective but we will confine ourselves to considering the impact of the decision on non-US structured debt transactions.

When Judge Peck's decision was first published the initial reaction from the rating agencies was dramatic. There were indications that the rating of structured finance notes would be capped at the rating of the swap counterparty not only in the case of a US incorporated counterparty but also in respect of non-US subsidiaries of US entities where the subsidiary acts as swap counterparty in a rated deal.

The rating agencies' response was viewed by many market participants as an over-reaction and did not take into account the protections already built into their swap counterparty criteria which are intended to avoid the issuer in a structured deal facing an insolvent swap countparty.

As we explained in our briefing "*Anti-deprivation: what next for the UK Structured Debt Market?*", for AAA/Aaa-rated securitisations the rating agencies require that swap counterparties must comply with their counterparty criteria which include requirements as to the maintenance of certain short-term and/or long-term ratings of the swap counterparty. In the event that a swap counterparty is downgraded, rating agency criteria require certain actions to be taken, for example, the transfer of the swap transaction to a party meeting the criteria, the posting of collateral or the provision of a suitably rated guarantee. In simple terms, the inclusion of the transfer, collateralisation or guarantee requirements enable each rating agency to satisfy itself that the risk of the insolvency of a swap counterparty affecting the securitisation cash-flows is sufficiently remote that it should not prevent the rating agency from awarding a AAA rating to the relevant notes. In the immediate aftermath of the US Bankruptcy Court's decision, Rating Agencies requested additional opinions to address the cross-border enforceability issues raised by the case but these

requests cut across their existing swap counterparty criteria, which permit the solvency of the entity to be assumed. It is unclear what such opinions added as there were already mechanisms for dealing with counterparty default and non-compliance with criteria.

At one point some rating agencies were not only requesting opinions expressly addressing the enforceability of the payment priorities provisions under English law following the insolvency of the swap counterparty but also asking for non-consolidation opinions from both a US and English insolvency perspective. These opinions were to confirm that, following the insolvency of the US parent of an English incorporated subsidiary, any insolvency proceedings in respect of the subsidiary would not be consolidated with that of its parent. While these opinion requests could be met from an English law, perspective, from a US perspective they posed a number of difficulties. As a result of the Lehman insolvency process where locally incorporated subsidiaries of a US parent have been subject to local insolvency proceedings, rating agencies now seem to be rating on the assumption that subsidiaries will file for insolvency locally and accordingly, the rating agencies have been satisfied with an English non-consolidation opinion only. The rating agencies should stand by their ratings criteria, in particular the replacement triggers and, on that basis, there should be no need for such an opinion.

Structural changes - can a clear distinction be drawn based on the jurisdiction of incorporation of the counterparty?

The rating agencies are still developing their policies in response to the US

"The rating agencies should stand by their ratings criteria, in particular the replacement triggers"

Bankruptcy Court's judgment in *Perpetual*. What is clear is that the rating agencies are distinguishing between transactions they view as non-US – involving English assets, an English security trustee and an English incorporated swap provider, for example – and transactions which have a US element. Trying to define "US element" remains difficult as the rating agency views are changing. However, what can be said is that the parameters have been set wider than merely that the swap counterparty is incorporated in the US, for example, to include English incorporated counterparties with a US parent (either as a direct parent or further up the ownership chain).

In respect of counterparties with no US parent (as a result of either direct or indirect ownership), there has been no change in the structuring of transactions. Termination payments to the counterparty are still subordinated following the counterparty's default.

In respect of locally incorporated subsidiaries of a US parent company (as a result of either direct or indirect ownership), as discussed above, the agencies seem to be assuming that local subsidiaries will file for insolvency locally. Logically, this would mean that, provided a legal opinion that any payment priorities are valid and enforceable in the jurisdiction of incorporation of the relevant counterparty, the rating agencies should be able to rate structures with payment priorities without any structural adaptation. However, transactions involving non-US subsidiaries of US parents are still being forced to be restructured.

Following the Bankruptcy Court's decision, US counterparties were effectively vetoed by the rating agencies. It seems that any transaction with a US counterparty which has subordination provisions will be capped at the rating of the counterparty. Practically, though, it seems unlikely that European issuers will be willing to mandate arrangers which are unable to provide at least a non-US incorporated subsidiary of a US bank to act as swap counterparty.

Structural changes - a big shift or merely tinkering with existing structures?

In some respects, simple changes have been made to all transactions. Independent of the changes made to swap structures as a result of the *Perpetual* litigation, there is a general trend of deconstructing swaps. As pricing of a particular swap is broadly speaking a function of its liquidity and simpler swaps are more liquid, this trend may alleviate some of the pricing pressure on certain swap transactions. However, breaking more complex swaps into their constituent parts is not a structural solution to the issues raised in *Perpetual*.

In response to the *Perpetual* litigation, transactions which include a flip provision will now also include a risk factor in the prospectus explaining the potential impact of the *Perpetual* decision on the repayment of the Noteholders in accordance with the transaction waterfalls. It is also possible to minimise the potential impact of the anti-deprivation principle (at least from an English law perspective) through careful

drafting of the transaction documents, as was recognised by the Court of Appeal in its judgment.

Arrangers have also been exploring alternative solutions to remove the need for the flip provision. These range from the dramatic, such as removing the swap transaction entirely and addressing the cashflow risk through increased enhancement, to the innovative, such as making use of options and more structured swaps. The permanent subordination of swap termination payments has also been considered by transaction parties. Nevertheless, all these options have pricing consequences and are therefore imperfect solutions to obstacles created by the over-reaction of the rating agencies.

One important distinction to make is that whether a structural change is necessary, and the extent of the change required, will be dependent on the ratings that the transaction is seeking to achieve for the most senior tranche of notes. The discussion above has been based on the assumption that the parties will be seeking a AAA/Aaa/AAA rating for the most senior tranche of notes. However, for transactions where the notes attract a lower rating (such as issuances in relation to regulated utilities or infrastructure projects) there is scope to argue that no structural changes are necessary as long as the swap counterparty has a rating equal to or higher than the ratings of the most senior class of notes.

Conclusion

The market recovery is fragile and, with the regulatory landscape continually evolving, transactions are under an immense amount of pricing pressure. Many transactions that were economically viable before the crisis are no longer so. Additionally, and as discussed in our previous article, central counterparty clearing is an inevitability which will result in pressure to simplify swap transactions. Against this backdrop it is to be hoped that the rating agencies will take the view that, for swaps with replacement triggers, no restructuring is necessary and the flip provision can continue to be used.

It is widely hoped that the Supreme Court will uphold the Court of Appeal judgment on the basis that secured waterfalls fall outside the anti-deprivation principle, following Patten LJ's judgment in the Court of Appeal. This would eliminate the need for additional risk factors, additional legal opinion analysis and would be welcomed by market participants. However, quite how the conflicting decisions of the US and the English courts will be resolved remains unclear and if Lehman entities successfully acquire affected notes pursuant to the order on 22 April 2010 discussed above, clarity may never be forthcoming.

12. Launch of the first French securitisation company

An interesting recent development in the French securitisation market has been the launch of the first domestic French securitisation company, Managed and Enhanced Tap (Magenta) Funding SAT, sponsored by Natixis in March 2010. This is the first example of such a company being incorporated and issuing *billets de trésorerie* – notwithstanding the fact that it has been possible to create such a company since the coming into force of the ordinance of 13 June 2008. Magenta Funding will act as an ABCP conduit vehicle for the securitisation of receivables including trade receivables or loans originated in France or elsewhere in Europe.

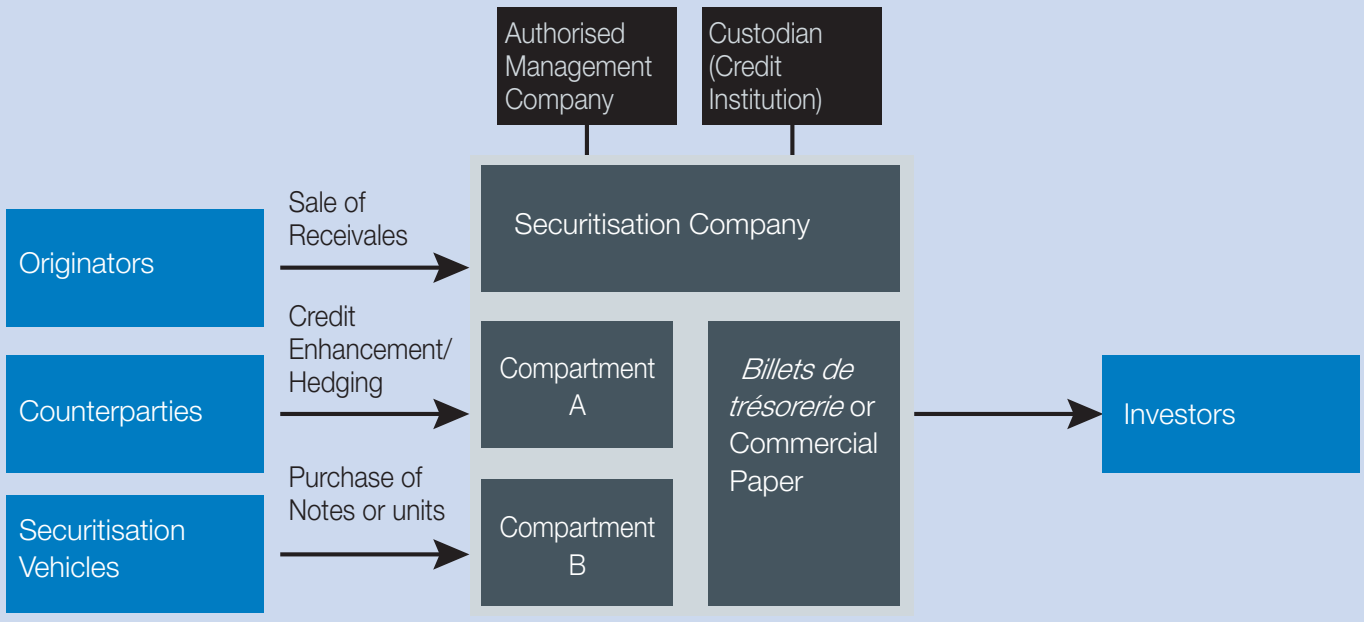
There are significant advantages to the use of this new form of vehicle and we anticipate that such French securitisation companies will be used frequently for French and pan-European securitisation and structured finance transactions.

A key feature of these companies is that they have express immunity from being subject to insolvency proceedings in France and are therefore bankruptcy remote by law. This differs from the position in other jurisdictions where "bankruptcy remoteness" is achieved by a combination of structural and contractual features (limitation on number of creditors, limited recourse nature of payment obligations and non-petition covenants) which may be supplemented by protection from certain insolvency procedures (e.g. the capital markets exemption which protects certain UK special purpose companies from being put into administration in certain circumstances). However, the French Monetary and Financial Code provides the securitisation company with an express statutory immunity from any French corporate insolvency proceeding. This creates a new bench-mark for the bankruptcy remoteness of structured finance vehicles.

The securitisation company has corporate personality, is subject to French corporation tax on its income and is therefore eligible to benefit from the network of double tax treaties negotiated between France and a wide range of other jurisdictions. This is a significant advantage compared with the French *fonds communs de titrisation* which – due to its lack of legal personality and its consequent exemption from corporation tax – often had difficulties in qualifying for double tax treaty protection. This hindered the use of *fonds communs de titrisation* as a central issuer for the securitisation of pan-European or global receivables portfolios where the underlying receivables are interest-bearing (e.g. multi-jurisdictional loan portfolios).

The use of a French company also potentially permits access to the

A new ABCP programme structure



European Central Bank liquidity and repo facilities which are not available to non-EU issuers – such as ABCP vehicles incorporated in Jersey.

The securitisation company can create compartments – these can be structured to be legally separate so that unless the documentation provides otherwise, the assets of the compartment are available only to meet the liabilities of such compartment. This gives structural flexibility and an ability to amortise the start-up costs by using the vehicle for a series of distinct securitisation or repackaging transactions. The structural flexibility permits certain transaction specific arrangements to be compartment specific such as transaction-specific credit enhancement or-hedging arrangements which relate, and have recourse, only to the assets of that particular compartment, whilst other arrangements may be at company level.

Securitisation companies must be managed by a management company which is authorised by the French *Autorité des Marches Financiers*. This gives comfort to investors that the manager is a French regulated entity and provides a structural barrier to the company attempting to de-localise its centre of main interests with a view to petitioning for insolvency in a jurisdiction other than France.

Whilst being well adapted to being used as an ABCP conduit vehicle or for the securitisation of French and European receivables, the companies can also be used for synthetic securitisations and to securitise certain forms of re-insurance risk. However, for the moment they can not be used to hold and directly securitise physical assets such as real estate or aircraft (except following enforcement of a security interest). Accordingly, their statutory bankruptcy-remoteness is not yet a complete answer to the issues raised in the *Coeur Defense* context which is explored elsewhere in this publication.

13. RMBS revisited

In this article, we observe how initiatives to promote transparency and disclosure in the structured debt market in the wake of the global economic crisis could shape the residential mortgage backed securitisation ("RMBS") market going forward.

European regulatory bodies and market participants have been working together, along with other interested stakeholders, on the implementation of sound and consistent disclosure requirements. A particular driver is the changes which will be required when a round of amendments to the Capital Requirements Directive ("CRD") are implemented at the end of this year for commencement in 2011. Of particular significance in this regard is new Article 122a of the CRD, which will require increased due diligence by investors of not only underlying assets, but also transaction structures and cash flows. In addition, the recent Bank of England consultation paper seeking views on proposals for its liquidity facilities (that is, the discount window facility) for the banking system has explicitly placed further emphasis on the desirability for enhanced disclosure and standardisation in the securitisation industry. The proposed revisions, which the Bank of England states would be adopted during 2011, would require counterparties to make publicly available granular information in the form of loan-level data for most asset backed securities and standardised summary tables in investor reports, as well as standardisation of key legal documents, summaries of structural features and cash flow models for each transaction. see also "*Investor Disclosure*" on page 1.

The shape of the UK RMBS market

The UK RMBS market is dominated by master trust issuance. Improving transparency and disclosure in relation to master trusts may well be tricky, as master trusts are typically highly structured transactions adorned with "bells and whistles" features which are designed to offer funding flexibility to the issuer/originator and are tailored to accommodate portfolios comprised of various different types of mortgage product. Master trust issuers typically have US issuance capability and hence have been required to provide loan stratification tables to investors. However, they have not historically been required to provide loan-level data. Providing such data would not be straightforward due to the large amount of data involved and the revolving nature of the master trust portfolios, which, in some cases, include hundreds of thousands of loans. Complying with requirements to provide more granular information and cash flow models in the form currently envisaged by the new regulations and industry proposals is therefore going to be particularly problematic for this type of transaction. In addition, the frequency of reporting proposed by the Bank of England in its consultation paper (i.e. the production of loan-level data on each bond payment date; and for revolving pool of assets, each time a new pool is added) will present particular cost and administrative challenges for master trusts.

In light of these challenges, we believe that there will be a shift towards simpler and more standardised residential mortgage securitisations in the form of stand-alone transactions. In our view, it is likely that, in the short to medium term, there will be an increase in issuance of stand-alone securitisations, with a good chance of stand-alone transactions gaining increasing prominence in the market over time. There are several reasons for this: *firstly*, the residential mortgage products being offered by lenders have become simpler in recent times, so there will be less need for the flexible features and added complexity of the master trust programmes, and, therefore, a move towards less opaque and more standardised structures; *secondly*, it is likely to be easier for both originators and investors to comply with new regulatory disclosure requirements, including the provision of cash flow models and loan level data, for stand-alone issues with discrete pool of loans than it will for master trusts; *thirdly*, it may well be that certain investors want exposure to a specific vintage of loan or product type, rather than to an originator's entire mortgage business; and, *fourthly*, investors may want greater ability to control, and potentially sell, a securitised portfolio in a default/enforcement scenario, particularly when the originator is insolvent. Although we do envisage a trend towards simpler, stand-alone RMBS transactions in the future, public RMBS issuances off master trusts over the past six months have shown that this product is still well received by investors and we believe that institutions will continue to use master trust programmes as a funding source going forward, not least because they require a number of periodic transactions to work efficiently and are attractive to investors who want exposure to the business of the originator rather than a specific vintage or portfolio. Consequently, we envisage in the short-to-medium term the development of parallel RMBS markets: master trust issuance and stand-alone issuance.

"We believe that there will be a shift towards simpler and more standardised residential mortgage securitisations in the form of stand-alone transactions"

Stand-alone RMBS structures

There are broadly three ways of structuring stand-alone RMBS transactions: the "additional class of notes" structure, the "modified master trust" structure and the "contractual seller/investor interest" structure, each of which has been used on securitisation transactions in the market.

The additional class of note structure uses additional classes of notes to provide credit enhancement for the transaction. The additional notes can be structured as fully paid up term notes or, if more flexibility is required (because, for example, the amount of enhancement would fluctuate during the life of the transaction) can be structured as Variable Funding Notes or as Partly Paid Notes. The advantage of structuring the enhancement as a note instrument is that it is a more marketable instrument than a seller interest and all cash flows from the portfolio can be applied down the issuer waterfall, which may simplify calculations and cash management.

Alternatively, a modified version of a master trust can be used. This structure uses a single tier, rather than a double tier, trust structure, whereby a special purpose company appointed as mortgage trustee holds the portfolio on trust for the seller and the issuer, and interest and principal payments on the trust property and losses thereon are allocated to the seller and the issuer according to a seller share and an issuer share, respectively. This is a one-off transaction structure, however, and does not allow for multiple transactions secured against the same revolving mortgage portfolio. Notwithstanding this, the mechanics of this structure operate in a similar (but simpler) way to master trust structures, with the seller share of the trust providing support for potential set-off losses and a mechanism for the seller to pay funds into the transaction to fund cash borrow backs under flexible mortgage loans.

"The Bank of England observed that there is no standardisation of offering documents, so each transaction requires individual, detailed analysis to identify the associated legal and structural risks, with it being difficult to extract even the most basic information"

The third potential structure is the contractual seller/investor interest structure, which operates in a similar way to the modified master trust structure for a single transaction, but rather than creating a trust, the mortgage loans are transferred by the seller directly to a special purpose vehicle issuer and a seller interest and investor interest in the revenue and principal receipts of the mortgage loans held by the issuer are created by virtue of a contractual arrangement and payments are made back to the seller by way of deferred consideration. This structure is, in our view, a simpler way of achieving the desired result than using the modified trust structure and also avoids the complicated bare trust tax analysis of the modified trust structure.

In addition to the simplification of transaction structures described above, other aspects of RMBS are likely to be simplified going forward. For example, swap structures may change as a result of rating criteria becoming more difficult to satisfy and there being less entities prepared to act as third party swap providers. This could result in a move towards simplicity, by moving away from swaps which are tied to the income generated on the portfolio towards more generic swaps which should be easier to value and replace. For example, rather than swapping a blended portfolio rate for LIBOR, swapping the Bank of England base rate for LIBOR and supporting this with additional credit enhancement, and making interest on junior classes of notes more "pass through" for notes which are being retained by the originator, based on the underlying mortgage rates rather than LIBOR. In addition, there is also scope for simplification in other areas, for example, by making payment waterfalls more straightforward.

Standardisation

One of the concerns raised by the Bank of England in its consultation paper, is the lack of standardisation of securitisation documentation. In particular, the Bank of England observed that there is no standardisation of offering documents, so each transaction requires individual, detailed analysis to identify the associated legal and structural risks, with it being difficult to extract even the most basic information, such as cash flow triggers and voting rights. Various industry initiatives are exploring the standardisation of securitisation documentation. For example, there is an ICMA discussion forum for market participants which is considering, amongst other things, the potential to standardise securitisation documentation. In addition, the

AFME/ESF has been actively engaged with members in an effort to standardise investor reports, definitions and documentation for stand-alone RMBS, which would serve as the starting point for documenting an RMBS transaction. This workstream is particularly useful as it is a forum for bringing together all aspects of the market, and includes representatives from issuers, investors, credit rating agencies and law firms, including Clifford Chance. The Bank of England, FSA and UK Treasury are also observers on these initiatives.

One of the AFME/ESF working groups in which we are participating is working on a standard form RMBS prospectus, including a standard form summary section and standard forms of disclosure for, for example, representations and warranties of the originator. The introduction of a standardised summary section of the prospectus which sets out the pertinent features of the transaction and cross refers to relevant sections of the prospectus for further detail will be helpful for investors and go some way towards addressing the Bank of England's concerns mentioned above. In addition, standardised definitions, another AFME/ESF working group, if successful, would help to eliminate confusion, for example, in investor reports, where similarly named fields have different meanings depending on the party issuing the report. Whilst a certain level of standardisation in the market may be achievable and the transaction documentation could usefully include standard key terms and certain standard definitions, in our view, it is unlikely that standardisation would be taken as far as, for example, creating a complete set of ISDA style standardised RMBS documents. Providing for the broad range of deviations which would be required from the standard documents, for example, because of the different mortgage products and origination practices, would not be practical and could well cause greater confusion for investors and more opaque documentation. The most important factor is that disclosure adds transparency and highlights differences from standard approaches and we do not believe that being overly prescriptive will achieve that purpose.

It is also worth noting that some market participants are supportive of standardisation in general, but others consider there to be a danger that, by producing standardised documents, any transaction which does not sit squarely within the standardised documentation is regarded as "off-market", with potentially pricing and other implications. In a similar vein there are concerns, particularly among UK RMBS issuers, that proposals such as the prime collateralised securities initiative, which aim to attach an imprimatur to certain transactions, will create a two tier market.

Transparency of offering documents can also be improved by including risk factors which are clear and concise and proportionate to the risk being described. Over the years, risk factors in prospectuses have tended to become long and rambling, with much repetition and disproportionate disclosure being given to certain *deminimis* risks, with some risk factors automatically being included as a matter of market practice rather than being evaluated on a transaction by transaction basis. We believe that, in the sprit of increased transparency, a more streamlined approach to risk factors should be adopted by the industry going forward. For example, there is a considerable amount of disclosure in relation to regulatory risk factors in RMBS transactions, and sometimes the identification of the actual risk is lost in the detailed disclosure which can run to several pages of text; furthermore, some of the regulatory disclosure will become increasingly irrelevant going forward as newer vintages of loans are being included in portfolios (for example, risk factors relating to the Consumer Credit Act) and the need for inclusion, and the level of disclosure, should be re-evaluated for each transaction on a case by case basis.

Conclusion

The move towards enhanced transparency and disclosure is a positive one for the industry and should increase investor confidence in the RMBS market; however, notwithstanding the fact that, of all the markets in asset-backed securities, the RMBS market is probably the most suited to a standardised initiative, there are, nonetheless, likely to be some significant practical challenges in implementing standardisation and other industry proposals around transparency and disclosure.

14. Regulated utilities still have the X factor

Despite the downturn in the markets over the last few years and the scarcity of new money investors in structured debt products, structured utility bonds issued in the regulated infrastructure sector have survived relatively unscathed and, over the last 12 months, have emerged from the credit crisis with renewed vigour attracting a significant tightening in spreads reflecting the increase in demand for long dated investment grade paper from fixed income investors (particularly looking to match inflation linked liabilities or looking for some extra yield pick-up from Class B bond issuance). A successful distribution of large amounts of "A" and "BBB" category paper has been achieved despite the absence of the monolines and a "AAA" credit wrap, whose participation was so instrumental in helping to develop the market for structured utility bonds.

Over the last ten years, many sponsors in the UK regulated infrastructure sector have looked to the structured whole business securitisation model as a key financing tool for refinancing historic acquisition debt and funding the challenging capital expenditure targets set for them by their regulators. Some of the large UK water and sewerage companies led the way but the model has since been adopted to some or a greater extent in the UK gas and electricity sectors. We have also witnessed other but less regulated companies such as BAA's London airports come to market with large debt issuance programmes which leverage off much of the legal and credit structures adopted by their pioneering cousins in the UK water sector.

So what has been the great attraction for sponsors and investors of companies that have generally been unloved and overlooked by the equity markets? Answer: Regulation, Regulation and Regulation! In short, the greater the economic regulation and the certainty of the economic contract between the utility and its regulator, the more predictable the revenue streams become for sponsors and investors. Regulated utilities benefit from high barriers to entry and the lack of threat of meaningful competition for their consumer base, charges are set on a five yearly basis under well established price controls (commonly referred to as "RPI – X") and investment is rewarded through a return

Recent regulated infrastructure issuance includes:

June 2009
Anglian Water Services Financing plc - issuance under its existing whole business secured financing programme of £100,000,000 Class B 6.755 per cent. Fixed to Floating Bonds due 2024

July 2009
Yorkshire Water Services Bradford Finance Limited - establishment of a whole business secured financing programme and initial issuance of £275,000,000 Class A 6.00 per cent. Fixed Rate Bonds due 2019, £200,000,000 Class A 6.375 per cent. Fixed Rate Bonds due 2039 and £175,000,000 Class A 2.718 per cent. Index Linked Bonds due 2039

December 2009
BAA Funding Limited - issuance under its existing whole business secured financing programme of £700,000,000 Class A 6.75 per cent. Fixed Rate Bonds due 2028 and £235,000,000 Class A Index Linked Bonds due 2041

February 2010
South East Water (Finance) Limited - issuance under its existing whole business secured financing programme of £130,000,000 2.5329 per cent. Senior Index Linked Bonds due 3 June 2041

March 2010
Wales & West Utilities Finance plc - establishment of a whole business secured financing programme and initial issuance of £100,000,000 Class A 2.496 per cent. Index Linked Bonds due 2035, £300,000,000 5.75 per cent. Class A Fixed Rate Bonds due 2030 and £115,000,000 Class B Fixed to Floating Rate Bonds due 2036

Dwr Cymru (Financing) Limited (Welsh Water) - issuance under its existing whole business secured financing programme of £140,000,000 1.859% Class B Index Linked Bonds due March 2048

April 2010
Yorkshire Water Services Bradford Finance Limited - further issuance under its existing whole business secured financing programme of £100,000,000 6.375 per cent. Fixed Rate Class A Bonds due 2039, £85,000,000 2.718 per cent. Class A Index Linked Bonds due 2039 and £450,000,000 6.00 per cent. Class B Fixed to Floating Rate Bonds due 2025

May 2010
Anglian Water Services Financing plc - issuance under its existing whole business secured financing programme of £130,000,000 2.262 per cent. Class A Index Linked Bonds due 2045]

on a regulated asset base which grows through capital investment and indexation. Furthermore, a combination of special insolvency regimes and regulatory ring-fencing add a degree of insolvency remoteness that would not apply to a typical UK corporate. All of these factors are a credit positive for structured debt issuance.

As we approach 10 years of structured utility bonds and the 20th anniversary of RPI-X, we take a look in this article at recent trends in the market and economic regulation. Whilst there have been challenges in successfully executing large structured utility refinancings (some of which we describe in more detail below), the legal and credit structures of the original groundbreaking transactions in the UK water sector have proven to be remarkably robust. Furthermore, whilst for reasons set out further in this article, it may prove more difficult for sponsors to find the necessary efficiencies to outperform the regulatory settlement, the shift in economic regulation is not expected to be so fundamental to cause infrastructure funds and investors to exit the market or end the bidding for utility companies in the M&A markets.

The X-factor - some thoughts on the future approach to price controls for UK network utilities

Introduction

Regulators across the UK's utility networks are facing a common problem. The price control regimes for the energy and water sectors put in place at privatisation are no longer delivering the easy wins that were once available; the imperatives of external factors such as climate change and shifts in the pattern

"So what has been the great attraction for sponsors and investors of companies that have generally been unloved and overlooked by the equity markets? Answer: Regulation, Regulation and Regulation!"

of consumption or supply mean that the price control regime is being directed towards an increasingly complex and diverse set of objectives; whilst at the same time both the water regulator (Ofwat) and the energy regulator (Ofgem) have been under considerable political pressure to keep prices down.

Investors and lenders have become familiar with the current regime of five yearly price reviews based on an RPI-X formula designed to squeeze out efficiencies and embraced (or at least accepted) by the regulated as an opportunity to outperform expectations and keep a share of the benefits. This model places great emphasis on a company's Regulated Capital Value or RCV (the nominal value of its regulated asset base) and the weighted average cost of capital or WACC (the allowed return on a regulated company's RCV) Over the next few years, a combination of the factors referred to above will lead to fundamental changes in the way in which the price control regimes in these two sectors operate.

Portents

There are already some signs of what price control settlements in the energy and water sectors will look like in the future. In November 2009, Ofwat published its final determination for the period 2010-2015 (PR09). This was rejected by one company – Bristol Water – whose determination is currently being reviewed by the Competition Commission. In December 2009, Ofgem published its final proposals for the electricity distribution price control review 2010-2015 (DPCR5) – which was accepted by all 14 distribution network operators (DNOs). Both of these price control settlements were introduced at a time of considerable uncertainty in the financial markets (making it difficult to price the cost of capital) and both contain new features which point to what future price controls will look like.

In addition to Ofwat's PR09 and Ofgem's DPCR5 price settlements, both regulators have publicly signalled their intention to review the way in which price controls are implemented. In March 2008, Ofgem launched the RPI-X@20 review to examine the current approach to price setting and to develop Ofgem's future strategy – Ofgem's emerging thinking on the RPI-X@20 review was published in January 2010 and the final conclusions are expected in the summer of 2010. Similarly, in April 2010, Ofwat published its "Water Today, Water Tomorrow" strategy document in which it declared its intention to roll out a "future regulation" programme. Ofwat has also set up an advisory panel to help develop its future strategy across a range of issues, including the form of future price controls. This programme will incorporate the recommendations made by the Walker Review into household charging, published in December 2009. Also in the mix is the recent announcement by the Office of Fair Trading (OFT) that it will undertake a "stock-take" of UK infrastructure, looking at how ownership and gearing affects outcomes for consumers.

Recent structural developments

Inflation Linked Hedging

Many sponsors, at the time of acquiring a regulated utility, have bought long dated inflation linked hedges as a means of initially hedging their floating rate bank exposure but also with a view to locking in spreads on subsequent inflation linked capital markets issues. Inflation linked swaps due to their accreting nature provide lower levels of gearing at the outset but also increasing volatility with respect to their mark to market. However, as the credit markets turned, issuers struggled to find capacity for index linked bond issuance-leaving sponsors with the choice of raising additional debt to terminate existing inflation linked hedging or to restructure all or some of their inflation linked hedges. However, whilst the swaps are often long dated to create synthetically the profile of a long dated inflation linked bond, inflation swap providers have required optional or mandatory breaks resulting in the risk that an Issuer will be exposed to a material termination payment which it will need to fund within its covenants by the raising of new debt. These early break provisions do not sit well with the customarily limited termination rights afforded to hedge counterparties in structured debt transactions. Furthermore, whilst historically refinancing risk has been addressed through maturity covenants limiting by a percentage of RAV the amount of debt falling due for repayment within 2 years and the period of the price control, the precedent transactions do not factor in the accreting notional amount of these hedges and the volatility of their mark.

Thus sponsors have had to adapt to the requirements of the rating agencies and investors by acceding to more complex hedging policy covenants to minimise refinancing risk but also to ensure a migration over time to a more predictable and stable inflation linked profile. These covenants have included lower levels of gearing whilst non-compliant inflation swaps remain in place, dividend lock-ups and additional indebtedness tests being set at lower gearing levels and excluding the benefits of non-compliant inflation swaps when calculating certain post-maintenance interest cover financial ratios. It follows also that the accreting notional amount that has a break within the two or five year testing period will count towards debt falling due for refinancing within the applicable maturity covenants. Therefore, the financial indebtedness maturity covenant which has long been a feature of these types of transactions and aims to restrict the amount of financial indebtedness falling due in any 2 or 5 year period and therefore maintain a healthy debt profile, has been adapted in recent transactions to take account of accretion on index linked swaps with an early or scheduled maturity date within the same 2 or 5 year period. Finally, regardless of whether the swaps are compliant for early break purposes, the super-senior nature of inflation linked hedging relative to bonds in the transaction waterfalls has resulted in a limitation on the aggregate accreting principal relative to debt if the sponsors wish to avoid the occurrence of a trigger event and a mandatory cash lock-up.

Dry Securitisations, Flipper Bonds and Partial Refinancings

Whilst historically the debt markets may have been deep enough to accommodate a "one shot" refinancing of acquisition bank debt incurred by sponsors in acquiring a utility business, this has proved particularly challenging for utilities acquired prior to the credit crunch but with soft or hard refinancing commitments on their bank debt. As a result sponsors have looked at other options ranging from partial refinancings through so called "flipper" bond issuance to a full refinancing by way of medium term bank debt under a 100 per cent. or substantially bank funded structured debt programme (a so called "dry securitisation"), tranched to reflect Class A and B funding and with maturities that allow an orderly refinancing over time in the capital markets. In addition, owners who might be looking to sell have used flipper bonds (so called because they can be "flipped" into a securitisation programme (with all that that entails such as detailed covenant changes and intercreditor arrangements) without noteholder consent as means of meeting current funding requirements but without necessitating an expensive liability management exercise for any prospective purchaser that would look to the structured debt markets as means of refinancing its acquisition were it to be successful. Flipper Bonds have been successfully (and efficiently) migrated to the whole business securitisations of Thames Water, Yorkshire Water and Wales & West Utilities Limited.

Stranding options for Legacy Bonds

Many utilities that have been acquired have had outstanding a series of plain vanilla bond issues, in many cases without significant covenant protection for bondholders. Often these bondholders have no particular interest in migrating into a securitisation and would rather be redeemed with their full spens make-whole. Thus sponsors and arrangers have had to look at other alternatives to secure the participation of these legacy bond investors. In several cases the weakness of the covenants in the legacy bonds have allowed sponsors as a last resort to proceed with establishing structured utility bond programmes and issuing off that platform regardless of whether the legacy bond investors consented to migrating the securitised terms. By exposing the investors to the risk of being stranded without many of the direct benefits provided to the securitised investors, it is often the case that all or a majority of the legacy bondholders will agree to migrate into the securitisation for an all in cost which is lower than their spens entitlement.

From these various initiatives can be drawn a number of common themes which give some shape to the future regulation of the energy and water sectors. These themes can be broadly described as follows - first, a much finer calibration of the rewards and penalty mechanisms embedded within the price control mechanism; secondly, re-assessing financeability and putting less emphasis on WACC; thirdly, a greater focus on outputs (as opposed to costs) and greater stakeholder engagement; fourthly, a longer term approach to the setting of incentive mechanisms.

Taking each of these in turn:

Calibration

In PR09, Ofwat introduced the Capital Expenditure Incentive Scheme (CIS) which is intended to incentivise companies to put forward challenging business plans prior to the price settlement and then to outperform the targets set by Ofwat. Companies are rewarded or penalised depending on how closely actual expenditure compares to forecast expenditure. The CIS mechanism is similar to Ofgem's Information Quality Incentive (IQI) which it introduced in DPCR4 and carried through to DPCR5.

In addition to the IQI mechanism, Ofgem also introduced a wide array of additional incentives or obligations in DPCR5 to encourage DNOs to behave in a particular way. These cover environmental incentives such as the inclusion of a £500 million low carbon network fund to enable DNOs to trial new technology; customer service incentives which reward or penalise DNOs according to measured levels of customer satisfaction; and network incentives to encourage DNOs to invest efficiently. As part of its approach to networks, Ofgem equalised incentives across all network expenditure, capitalising 85% of all network operating

"Regulators across the UK's utility networks are facing a common problem. The price control regimes for the energy and water sectors put in place at privatisation are no longer delivering the easy wins that were once available"

or investment costs (other than management costs and overheads) and depreciating them over a 20 year period. This was aimed at ensuring that, when choosing between replacing or repairing capital assets, DNOs' incentives were not being skewed by the different regulatory treatment of opex (fast money – recovered in the year of expenditure) and capex (slow money – added to RCV and recovered over time). This approach was endorsed in Ofgem's emerging thinking on RPI-X@20.

The cumulative effect of these various mechanisms will be to disaggregate the potential upsides or downsides of a price control settlement. This will make determining whether or not a given settlement will provide a solid financial basis for the lifetime of the price control period a real challenge – particularly for those one step removed from the price review process.

Financeability: a move away from an industry-wide WACC

Both Ofwat and Ofgem have a statutory duty to ensure that licensed companies are able to finance the carrying out of their regulated activities. Under the current RPI-X model, this has been achieved by including within the level of revenue that a regulated company is allowed to recover, an allowed return on the RCV – the WACC. Despite the recent turmoil in financial markets, both recent price settlements have adopted challengingly low WACCs – in PR09, Ofwat applied a post tax WACC of 4.5%; for DPCR5, Ofgem adopted a WACC of only 4%. There are two identifiable trends at play in arriving at this level of WACC.

First, both Ofwat and Ofgem appear to be stretching the concept of financeability. The key financial ratios employed by Ofwat for PR09 were cash interest cover; adjusted cash interest cover; funds from operations:debt; retained cashflow:debt; and gearing. For a company to be considered financeable Ofwat targeted financial ratios consistent with an A-/A3 credit rating. In PR09, Ofwat recognised that three companies (Bristol, South East and Thames) would not meet this financeability test as a result of significant growth in their RCV. For each of the three companies, Ofwat assumed shareholders would inject more equity in order to allow the regulated business to finance its functions. This implies that Ofwat interprets its duty to ensure that water companies can finance their activities in a way that does not require Ofwat to set the WACC at a level that will ensure a well-managed company is consistently able to maintain the target financial ratios. This point is currently under appeal in the Competition Commission, where Bristol Water are unsurprisingly making the point that if Ofwat can reach the view that a company is financeable, even where its target financial ratios are not met, on the basis of an assumed equity injection, then this undermines the notion of financeability. Put simply, once you allow Ofwat to

assume an injection of equity, there will never be a situation where a company does not have access to finance. This strips any meaning from the duty imposed on Ofwat to ensure that all regulated water companies are able to finance their functions. However, Ofgem proposes to follow a similar approach to Ofwat. In its emerging thinking on the RPI-X@20, Ofgem set out "straw man" principles on financeability which acknowledge that, provided allowed revenues cover financing costs on average over time, the fact that they may not do so at any particular point in time would not be sufficient reason to adjust the level of allowed revenues (or the WACC). As a consequence, Ofgem has also signalled that it would consider moving away from using the same financial ratios as the rating agencies when assessing financeability – in particular by placing less or no emphasis on short term cash flow ratios.

Secondly, the increasing complexity of the incentive schemes has meant that although the headline level of return on RCV may be quite low, there is scope for additional upside in capturing individual incentive payments. In DPCR5, Ofgem formalised this by adopting a measure it called return on regulated equity (RORE). Ofgem's RORE analysis involved it looking at DNO performance against Ofgem's assumed level of costs; the assumed cost of debt and level of gearing and, importantly, the scope for DNOs to earn additional revenues through the various incentive schemes. For DPCR5, Ofgem estimated that a plausible upside return would be between 10% and 13% - considerably in excess of the headline post tax WACC figure of 4% (4.7% pre-tax). By holding the WACC down and shifting anticipated returns onto the incentive mechanisms, Ofgem is effectively making the DNOs run to stand still – those DNOs who stumble and do not outperform will suffer a decrease in their overall rate of return; a decrease from an already low base.

Another development heralded in Ofgem's RPI-X@20 review is the prospect of a "variable WACC" – in other words, rather than a single WACC being applied across an industry, individual regulated companies would be rewarded with an improved WACC where they have established a track record of planning and delivering efficiently.

All of these developments will serve to undermine the role of the WACC in future price settlements.

Output-driven regulation and enhanced stakeholder engagement

A key theme of Ofgem's RPI-X@20 review is that future price reviews should focus on outputs rather than inputs. Outputs should deliver both a sustainable energy network and secure value for money and Ofgem anticipates a number of output categories comprising reliability, safety, environmental targets, conditions for connecting to network services and customer satisfaction. Despite this change of focus, there is no suggestion that Ofgem intends to adopt a laxer approach to costs. Indeed, one proposal being put forward by Ofgem is to introduce competition into the delivery of outputs in order to lower the cost of delivery – which could involve regulated companies transferring ownership in assets to third parties or even having their licence revoked for persistent non-delivery.

As part of an output driven process, Ofgem anticipates that future price reviews will involve regulated companies proposing their own targets, taking into account legal requirements and input from stakeholders such as customer groups. These proposed targets would then be assessed by Ofgem (which would have conducted its own stakeholder research) before the final price settlement was reached. Regulated companies would be rewarded according to how well they achieved the defined outputs – this would involve assessment against qualitative criteria such as customer satisfaction. Different companies would be subject to differing levels of scrutiny.

One specific proposal which has attracted a lot of comment is Ofgem's suggestion that in order to increase stakeholder engagement in the price setting process, third parties should have the right to challenge the final price settlement (currently only regulated companies can do this). This proposal has the support of large customers such as Centrica, but other observers have claimed it would introduce considerable uncertainty and delay into the process and shift the main focus of the price setting process to the appeal stage in the Competition Commission.

"These developments will significantly increase the complexity of the price review process and introduce a greater degree of subjectivity both in the targets set and the level of performance achieved (which in turn will impact the level of return received by regulated companies)"

Although it has not echoed Ofgem's proposal of a third party right of appeal, Ofwat has also taken steps to focus on a more outcome-led and stakeholder-driven approach. In the recent PR09 price settlement, Ofwat introduced the Service Incentive Mechanism (SIM) which will replace the overall performance assessment (OPA) used to date. The key difference between the two mechanisms is that whereas OPA measured performance against a range of fixed indicators (for example speed of responding to calls), SIM attempts to measure the overall customer experience and so is more qualitative. As for OPA, SIM will rely on both a reputational incentive (Ofwat published league tables) and a financial incentive – ranging from +0.5% to -1%.

These developments will significantly increase the complexity of the price review process and introduce a greater degree of subjectivity both in the targets set and the level of performance achieved (which in turn will impact the level of return received by regulated companies).

Longer term price controls

Currently, both Ofgem and Ofwat set prices on a five yearly basis - although Ofwat requires companies to publish a strategic direction statement setting out the long term strategy of the business. Both Ofgem and Ofwat have indicated that they will consider whether to move to a longer price control period. Ofwat have yet to publish anything concrete in this regard, but in May 2010, Ofgem published a paper setting out its current thinking on the length of the price control period.

Ofgem envisages extending the price control period to between 8 and 10 years, with a "mini-review" half way through that period to check certain pre-specified aspects (for example whether output requirements remain appropriate). Allowed revenue would be adjusted within such period to reflect rewards or penalties accrued and there would need to be a series of re-openers or adjustment events that would allow the price control settlement to be revisited part way through the period upon the occurrence of certain defined events – for example a change in the cost of an underlying input or a category of inputs above or below a given level.

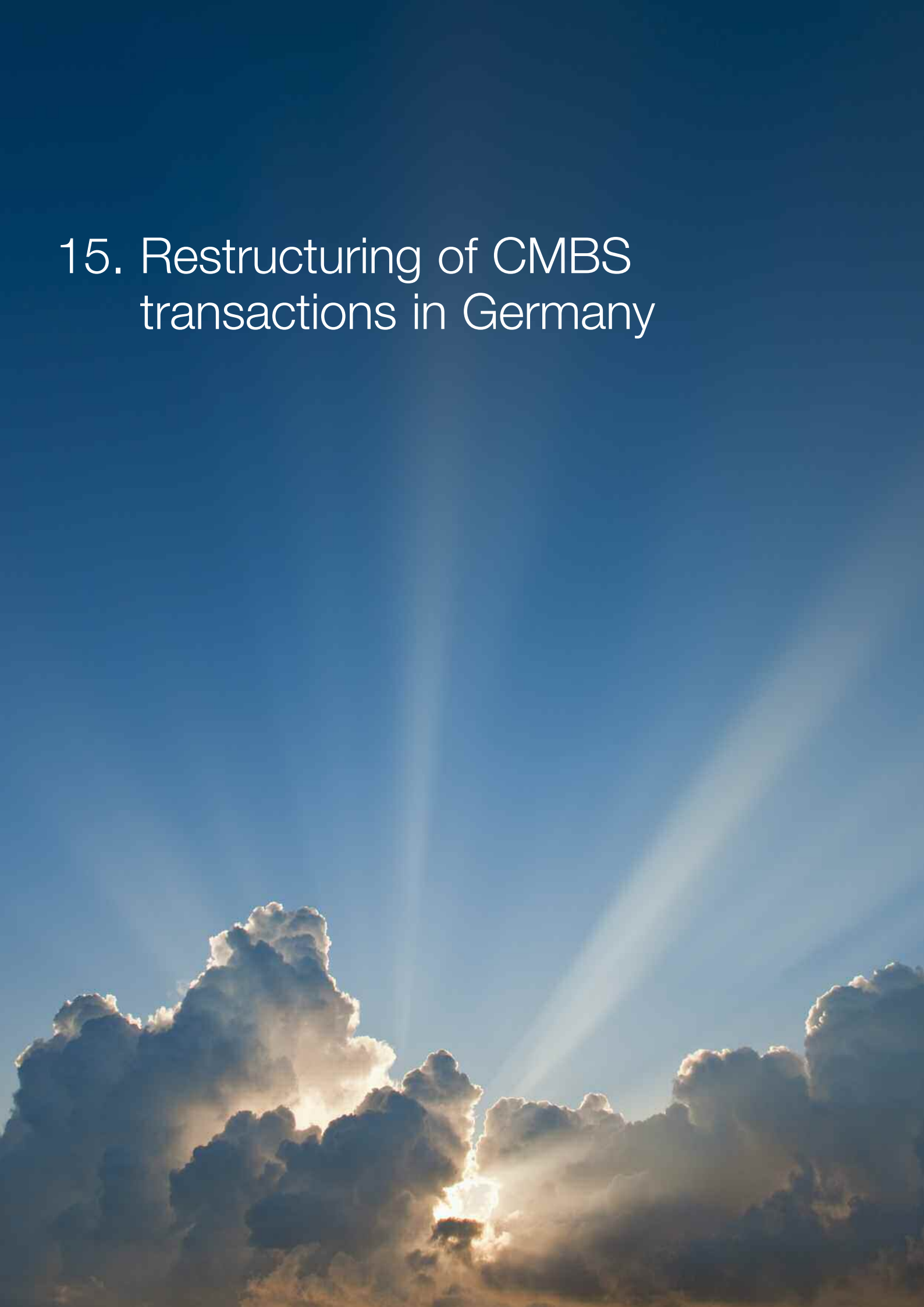
The impact of a longer price review period will depend how it is structured – a longer period should in principle increase certainty, although this will have to be balanced against the need for mini-reviews mid-term or a more extensive set of re-openers.

Conclusion

So, looking into the future what can we expect?

- More complexity – price control is no longer about squeezing costs out of inefficiently-run former public utilities, it is about sending increasingly complex pricing signals to network operators and others in order to incentivise them to direct expenditure in a way which will further broader regulatory objectives; most particularly sustainability (which is at the heart of both Ofgem's and Ofwat's priorities).
- Less clarity over the ability of a regulated company to keep consistently within accepted financial ratios – regulators will tolerate short term cash flow difficulties and the overall scope for a regulated company to outperform a price settlement will be more difficult to assess than it is now.
- A more involved process – whether or not third parties are given the right to appeal the final price settlement, their input will become increasingly important in defining the settlement and in determining the level of reward a company will achieve at the end of the price control period.

15. Restructuring of CMBS transactions in Germany



In the years up to and including 2008 Germany saw an unprecedented boom in CMBS transactions securitising loans which are secured on German commercial properties. A number of the loans have experienced difficulties for a number of reasons. Although the scope of this publication means that this article is not intended to cover all aspects of this topic, it focuses on some of the key issues surrounding such transactions and their restructuring.

Common issues on German CMBS loans

A number of different situations can arise under German transactions, most of which are not unique to Germany and have been encountered across European CMBS transactions. The three presently most typical situations are the following:

Obligations exceed assets

As in many other jurisdictions, the German market has witnessed a trend in which the value of the properties has decreased below the value of outstanding principal under the financing of such loan.

Overdue payment obligations

In many instances borrowers approach lenders and servicers with a request to allow for certain dedicated funds to be released and used for the purpose of paying outstanding invoices for capital expenditures, services related to the property or simply taxes.

Obligations exceed assets and shareholder loses interest in continuation of shareholding

In situations where the equity provider to a borrower, whose outstanding obligations exceed its assets, comes to the conclusion that its shareholding will not yield any further returns, it might take the view that it would be sensible to either file for insolvency or transfer the shares in the borrowers to the lender or a person appointed by the lender. This is often combined with various threats to file for insolvency and a request to reduce outstanding commitments by sponsors to make payments.

Strategies to restructure a German loan secured on German real estate

There are various approaches to most issues and no single approach is likely to be the only correct approach to a given situation. Here are a few possible ways of dealing with any given situation. The approach which should be used in a given scenario will depend on a number of factors including, without limitation, a thorough commercial and legal analysis as well as the factual willingness of all parties to cooperate.

Waiver

A (temporary) waiver may be appropriate in situations where an event of default such as an LTV breach has occurred, but where the borrower continues to meet its payment obligations and its financial condition appears otherwise stable, so that an enforcement does not seem to be a compelling measure at this stage.

Standstill

If an event of default under a loan has occurred, the lender may agree not to pursue any remedies and, in particular, not to accelerate the loan within an agreed period of time on the basis that the borrower otherwise complies with its obligations under the loan. This provides the borrower with "breathing space" to propose a solution to the lender on how to proceed with respect to a potential restructuring.

Prolongation

Another option to consider in the case of (anticipated) payment shortfalls of the borrower, in particular due to refinancing difficulties at maturity, is the prolongation of the loan, thereby speculating on more favourable market conditions at a later date. However, in the case of CMBS loans, there are additional constraints. The notes issued in CMBS transactions which are backed by such CMBS loans regularly mature two or three years after the loan within a so-called "tail period" which is intended to give sufficient time for enforcement in the event that the loan defaults. Noteholder consent is regularly required if it is considered to extend the term of the loan until after the maturity date of the notes. Such noteholder consent is often difficult to obtain in practice.

Taking over the shares in the borrower or taking over the properties

As mentioned above, a lender may find itself forced to "take over the keys". This means a situation in which it is asked by the sponsor of the borrower(s) to take over the shares in the borrower(s) or to acquire the properties. This can happen, for example, where the equity provider to a borrower is of the view that its shareholding will not yield any further returns and that it has no further other commercial interest in the transaction (for example, as an asset manager). In such case the request to "take over the keys" can be emphasised by a threat to file for insolvency, in particular where it is likely that any forced sale of the properties (within or outside of insolvency proceedings) will lead to a significant decline in value thereof.

A transfer of the properties to the lender or a person designated by it would trigger real estate transfer tax. This may be avoided in a share deal by transferring the shares to two independent transferees, as real estate transfer tax will only be

triggered if 95% or more of the shares in a borrower are (directly or indirectly) unified in a single taxpayer after the sale. A further point to consider is whether junior ranking encumbrances exist, as these will not be extinguished upon the taking over of the properties, which can provide for significant nuisance value.

Due diligence may be required to assess whether the borrowers are subject to any liabilities which are substantial and were not apparent from the lender reporting obtained under the loan, as such liabilities would be taken over in case of a share transfer and the equity sponsors will most likely not be willing to provide for indemnities in such cases.

Finally, such a transaction will always also be driven by tax considerations and it is important to analyse this in detail prior to implementation.

Enforcing and insolvency

Where a loan is accelerated following an event of default, this will most likely lead to an insolvency of the borrower due to illiquidity, as it would usually not be able to refinance the full repayment amount immediately.

Enforcement of the security over the properties by way of compulsory auction (*Zwangsversteigerung*) may be considered, however, while no co-operation by the borrowers or its insolvency administrator is required, this is usually a lengthy court-controlled process with only limited influence by the lender.

Another option for the lender in an enforcement scenario is to gain access to the cash flows generated by the properties by way of forced administration (*Zwangsverwaltung*) or, alternatively, enforcement through private "cold" administration by way of agreement with the insolvency administrator.

"A lender should carefully consider whether a borrower who is in financial difficulties will be able to survive in the medium term and hence whether prolongation of an existing loan or the advancing of new money is a viable option"

In the case of all enforcements it is important that the originals of the relevant land charges and security documents are located and can be produced when required.

Lender liability and delayed applications to open insolvency proceedings

To be determined independent of insolvency regime applicable to borrower

The question of whether a lender would be in danger of being subject to lender liability if it does not enforce a loan and thereby prolongs the "life/trading" of, or delays the application for the opening of insolvency proceedings regarding the company, thereby deepening the damage done by the ultimately insolvent borrower, is to be answered under German torts law (*Deliktsrecht*) and not dependent on the insolvency regime of the borrower. The general line adopted by the German Federal Court (*Bundesgerichtshof*) is that the non-enforcement of a loan (which would theoretically be enforceable) would in itself not trigger such a liability based on contravention of public policy. Further facts would need to be present in addition to the absence of enforcement. The German Federal Court stated that such facts could, for example, without limitation and much simplified, be present where

(i) economic power or pressure is exercised by the lender vis-à-vis the borrower or another form of influence was exercised on management for its own benefit; or

(ii) other creditors of the borrower are misguided regarding the creditworthiness of the borrower, for example, where the lender, e.g. in the context of a workout, does not act neutrally but is actively involved in identifying and persuading third party creditors to advance new credit or enter into new contracts for the delivery of goods or services or grants new credit lines to avert a pending insolvency.

How to avoid lender liability

In view of the above, a lender should carefully consider whether a borrower who is in financial difficulties will be able to survive in the medium term and hence whether prolongation of an existing loan or the advancing of new money is a viable option. In order for the lender to demonstrate that its decisions are based on a sound footing, it is advisable to obtain a workout opinion (*Sanierungsgutachten*) which is usually written or verified by independent accountants. While it is theoretically possible to demonstrate the positive outlook without a workout opinion, such opinions have become increasingly common in Germany and provide lenders with the most reliable defence when faced with the allegation of lender liability.

In this context, the Institute of Public Auditors in Germany (*Institut der Wirtschaftsprüfer, IDW*) has published its standard IDW S6 "Requirements for the preparation of a restructuring plan", which sets forth a number of requirements to be analysed in the context of a workout

opinion (*Sanierungsgutachten*) in order to assess whether a restructuring of the relevant company is likely to be successful. These include a description of the current economic situation, an analysis of the cause and level of the crisis and proposed measures to avert the crisis.

As it requires some time to prepare a restructuring plan and workout opinion on the feasibility of such plan, a bridge loan (*Überbrückungskredit*) to a company in crisis will not generally be considered contrary to public policy (of course this is a case by case question). Such a loan will not result in liability of the lender if it is made in order to prevent illiquidity during the period required for the preparation and examination of the restructuring plan.

For the avoidance of doubt, a mere standstill is not technically a prolongation, even if it presents a defence to payments which may otherwise, without the standstill, fall due. However, it is important that a standstill does not factually result in a prolongation in the disguise of a standstill because courts may then treat it similarly (in which case a workout opinion is advisable to avoid lender liability).

A further important factor to avoid lender liability is to ensure that the borrower retains control of its operations, i.e. the lender should not (either itself or through a person close to it) take over the management of the company or otherwise deprive the management of its power to act for the company or exert substantial influence on its business operations.

"Threats" to file for insolvency

It is not uncommon that demands from borrowers are combined with a more or less direct hint that the borrower intends to file for insolvency, unless the demands are complied with. For the avoidance of doubt, it is important that any party which is faced with such a situation does not react with a request not to file for insolvency as this can constitute an act of instigation to delay the opening of insolvency proceedings which is a criminal offence under German law. It is in the sole discretion of the management of a German legal entity to file or not to file for insolvency. What, however, can be done is to express a view (if it is true) that one is positive and hopeful about the progress of the ongoing negotiations (a so called "flower letter"). This can then factually help the management of the relevant German borrower to form a positive view about the state of negotiations and may support its positive continuation prognosis for the duration of the negotiations (if appropriate).

Special focus – insolvency considerations

When is German insolvency law relevant?

German insolvency law applies when a borrower can file for insolvency in Germany, either through main or secondary proceedings.

Main insolvency proceedings can be opened against a borrower where the "centre of main interest" of the borrower is based in Germany within the meaning of the European Council Regulation (EC) No. 1346/2000 (the "EU Insolvency Regulation"). While there is a rebuttable presumption that a company has its "centre of main interests" in the jurisdiction in which it has the place of its registered office, it is a question of fact where the actual place of the "centre of main interest" is and this may also change with such facts.

After the opening of insolvency proceedings in another member state of the EU, German courts will only have the jurisdiction to open territorial secondary insolvency proceedings in Germany (liquidation proceedings restricted to the assets situated in Germany) if the borrower has an "establishment" in Germany. An "establishment" requires that the borrower carries out a non-transitory economic activity with human means and goods. Further, a minimum level of organisation is required, so that simply the situation of assets of a person and the place where the obligors of contractual claims of a debtor are situated should ordinarily not lead to "establishment" in that place. It is therefore unlikely that a foreign borrower who owns properties situated in Germany could be subject to secondary insolvency proceedings unless Germany is also a place from which economic activities are exercised on the market and these activities are not purely occasional.

Where main insolvency proceedings are initiated outside of a member state of the EU where the EU Insolvency Regulation applies (this would be relevant where e.g. insolvency proceedings are initiated in offshore countries such as the Isle of Man or the Channel Islands), secondary proceedings in Germany can be opened if the debtor has a branch in Germany or the debtor has other assets located in Germany and the creditor filing an application has a particular interest in the opening of such territorial proceedings. Such interest would need to be assessed on a case by case basis. The territorial proceedings would be limited to the assets located in Germany.

How can it become relevant?

If insolvency proceedings are opened in Germany, under certain circumstances the insolvency administrator may challenge transactions which are detrimental to other insolvency creditors,

subject to certain hardening periods. Where a challenge is successful, the assets that were the subject of the relevant challenged transaction have to be returned to the estate and the original consideration for such assets (if any) becomes an unsecured claim against the insolvency estate.

By way of example, any security given to the lender whilst the borrower is unable to pay its debts when due may be challenged and set aside if the lender knew at the time of taking the security that the borrower was illiquid or if it had knowledge of circumstances that could lead to this conclusion. The hardening period in this case is three months prior to the filing of a petition for the opening of insolvency proceedings.

Further, security granted which the security provider was not contractually obliged to provide or not obliged to provide at the time may be challenged. In this case, the hardening period is a minimum of one month, but an extended hardening period of up to three months prior to the filing of a petition for the commencement of insolvency proceedings applies if the security is given either at a time when the person providing the security is in a condition of illiquidity or if the beneficiary knew that the granting of the security would be detrimental to other creditors.

In other cases, hardening periods may be longer (e.g. four years where a lender has been granted security and the borrower does not receive any consideration or benefit from the granting of the security or ten years where the security was granted by the borrower with the intention to harm creditors and the beneficiary has knowledge of such intention).

The question of whether an act of the borrower may be subject to challenge may also arise where the borrower waives a claim it may have against the sponsor as part of the overall restructuring negotiations with the lender.

What can trigger a filing for insolvency under German law?

There are two reasons which compel the filing for insolvency proceedings, over-indebtedness and illiquidity. Pending illiquidity, i.e. a situation in which management of a company comes to the view that illiquidity, while not yet imminent, is pending, allows management to file voluntarily.

Over-indebtedness

Under German law, a situation where the assets are exceeded by liabilities is referred to as a status of over-indebtedness and, in the case of a German borrower, unless (under an exemption which is in force until 2014) a positive continuation prognosis can be presented by management to such German borrower, this triggers an obligation to file for insolvency without undue delay and no later than 21 calendar days following the assessment of such over-indebtedness.

One question on which there is no clear answer is whether a company the liabilities of which exceed the assets can have can have a positive continuation prognosis in light of the arrival of repayment dates in CMBS loans which cannot be moved without extension of the CMBS bonds. While a positive continuation prognosis requires a predominant likelihood of the ability to meet payment obligations as they fall due during the current and the next business year, there is still a certain discretion for management in assessing this.

Illiquidity

A borrower is considered to be illiquid within the meaning of German insolvency law where it is not able to pay its debts when due. Whether or not a creditor actually demands payment is not decisive – any payment obligations which are due have to be considered. A temporary liquidity gap (*Liquiditätsengpass/ Zahlungsstockung*) of less than 2 weeks will not lead to illiquidity where such gap can be closed by expected payments, new loans or the liquidation of assets within a short period of time. However, failure to provide for sufficient liquidity within such period will generally trigger an obligation to file for the opening of insolvency proceedings.

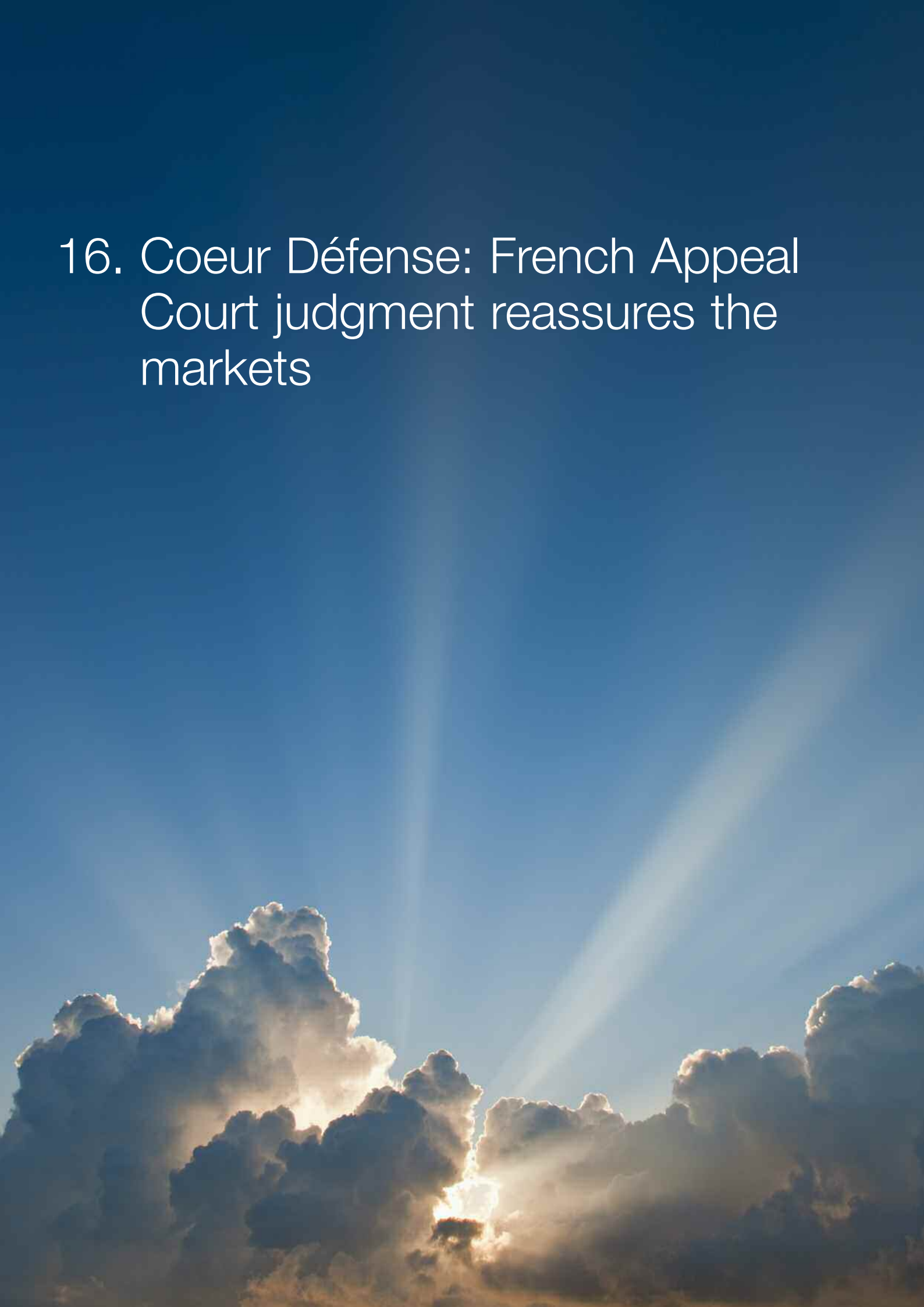
A borrower may also be considered illiquid if it is only unable to fulfil a small portion of its payment obligations due, unless the amount is insignificant. In this context, the German Federal Court (*Bundesgerichtshof*) generally considers an amount of less than 10% of the payment obligations due to be insignificant.

Illiquidity may only be temporarily "cured" by a deferral of payments which prevents the relevant payment obligations from becoming due, however, a deferral coupled with further restructuring measures as described above may prove to be a useful tool for the reorganisation of a borrower.

Conclusion

Some of the considerations above may be relevant to CMBS restructurings in Germany only. One aspect, however, that will be common to all jurisdictions is that the choice of the appropriate restructuring measures will require a thorough commercial and legal analysis and depend on the willingness of all parties to cooperate.

16. Coeur Défense: French Appeal Court judgment reassures the markets



In its judgment on 25 February 2010, the Paris Court of Appeal annulled the opening of safeguard proceedings in relation to Heart of La Défense SAS and Sàrl Dame Luxembourg (FCT Windermere XII). A similar judgment was rendered on the same day by the same court in the "Mansford" case, another real estate acquisition structured financing.

The safeguard proceedings in relation to these companies had previously cast a significant chill on the French real estate finance and CMBS markets.

Although the *Coeur Défense* decisions are the subject of a challenge before the French Supreme Court, the two cases of 25 February 2010 have reassured market participants and should deter future abuse of the safeguard procedure where the survival of the core activity of a company is not threatened and the only purpose of the proceeding is to preserve shareholders' interests and to unilaterally impose on creditors a re-negotiation of their debts.

Background

The judgments of 3 November 2008 opening safeguard proceedings in relation to Heart of La Défense SAS ("Heart SAS") and its Luxembourg parent Sàrl Dame Luxembourg ("Dame Lux"), shocked the financial markets. Heart SAS was a special purpose vehicle which was the borrower under the EUR 1.64 billion property financing secured on the Coeur Défense complex in La Défense. Dame Lux had provided a limited recourse share pledge ("*cautionnement réel*") to secure the debt of Heart SAS. The financing was also secured by other security interests, which included a French security assignment of all claims under the leases of the Coeur Défense complex made under the *Loi Dailly* regime.

The collapse of Lehman Brothers resulted in the downgrading of the Lehman entity that provided an interest-rate hedge to Heart SAS, triggering an obligation upon Heart SAS to replace this swap counterparty. Having failed to find a substitute swap provider at an equivalent cost, the President of Heart SAS filed for the opening of a safeguard proceeding and a similar filing was made for Dame Lux.

The markets had not anticipated that safeguard proceedings would be available in relation to a special purpose company such as Heart SAS, and had also not anticipated that a Luxembourg holding company such as Dame Luxembourg could be subject to French safeguard proceedings. Market perception was exacerbated by the fact that the loan had been transferred to the *Fonds Commun de Titrisation* Windermere XII under a securitisation transaction.

Appeal court judgments of 25 February 2010

The judgments opening safeguard proceedings in respect of both companies were annulled by the Paris Court of Appeal:

Heart SAS

The Paris Court of Appeal focused on the core test for the opening of safeguard proceedings given by Article L. 620-1 of the French *Code de Commerce*, namely that the enterprise is facing difficulties which it is not able to overcome (at the time of the judgment the test also included that these difficulties were of a nature leading to a cessation of payments). The purpose of the procedure is to facilitate the re-organisation of an enterprise to permit it to pursue its economic activity, maintain employment and stabilise its liabilities.

In this context the Court focused on the fact that the core economic activity of Heart SAS is the ownership of its property at Coeur Défense and the activity of exploiting this property by leasing it to its tenants. In a detailed factual analysis the Court concluded that at no point had Heart SAS proven that it was in fact facing insurmountable difficulties in pursuing its core activity of leasing and profiting from its building.

The fact that Heart SAS was obliged to replace a hedging swap with Lehman by a swap with another counterparty at greater cost and that, if it failed to do so, it could be in default under its loan agreement was not seen a sufficient reason to permit it to commence safeguard proceedings. The higher cost of this swap agreement did not demonstrate an insurmountable difficulty in pursuing its core activity of leasing its building. Instead the Court characterised the filing for subsequent proceedings by Heart SAS as an attempt by the company to mis-use the safeguard proceedings to impose on its lenders a re-negotiation of the contracts which it had entered into against civil law principles. The fact that a default under the loan could lead to a change of shareholder by reason of the enforcement of the share pledge granted by Dame Lux was not viewed as affecting the ability of Heart SAS to pursue its activity.

"The safeguard proceedings in relation to these companies had previously cast a significant chill on the French real estate finance and CMBS markets"

Whilst the judgment does not exclude the use of safeguard proceedings for special purpose companies, it requires a factual analysis of the real economic activity of a company and clearly divorces the survival of this activity from that of the ownership of the shareholding of a company.

Dame Lux

The Court took into account a number of factors in reaching the conclusion that the opening of safeguard proceedings in relation to Dame Lux was not appropriate:

- its core economic activity is that of acting as a holding company which manages a portfolio of shareholdings;
- it had not demonstrated that it had itself suffered difficulties in pursuing its own activity;
- it had not demonstrated that the guarantee it had granted was other than of a limited recourse nature which would be discharged in full upon the enforcement of the pledge over the shares it holds in Heart SAS;
- after the enforcement of the pledge over the shares in Heart SAS, Dame Lux would have sufficient financial means to pursue its core activity of being a holding company.

Taking into account these factors the court concluded that it was not legitimate for Dame Lux to initiate safeguard proceedings solely for the purpose of frustrating the enforcement of an out of court foreclosure provision

"The Court characterised the filing for subsequent proceedings by Heart SAS as an attempt to abuse the safeguard proceedings to impose on its lenders a re-negotiation of the contracts which it had entered into against civil law principles"

(*pacte commissoire*) over the shares it holds in Heart SAS - especially given that Heart SAS could pursue its core activity (of leasing and exploiting the Coeur Défense complex) regardless of who its shareholder was.

The Court did not explicitly address the question of whether Dame Lux had its centre of main interests in France for the purpose of the European Insolvency Regulation.

Interest of creditors to oppose safeguard proceedings

The Court considered that an individual creditor had a personal and legitimate interest different from the interest of its debtors the creditors collectively to appeal against the decision of the judgments opening the safeguard proceedings (*tierce opposition*) when the debtor concerned has mis-used the safeguard proceedings only to impose on the creditor a re-negotiation of a contract or to frustrate the enforcement of a contractual right. The Court confirmed that such a creditor is entitled to appeal against the judgment opening the safeguard proceedings, despite the fact that the interest of the creditors as a whole is represented by a court-appointed officer.

Dailly security assignment

Under *Loi Dailly*, the transfer of the receivables is enforceable as against the assignor and its third party creditors upon the dating of the form of assignment. The Paris Court of Appeal confirmed that the validity and enforceability of a *Loi Dailly* security assignment are not affected by the opening of insolvency proceedings in respect of the assignor of the receivables. The beneficiary of a *Loi Dailly* assignment can notify the assigned debtors notwithstanding the opening of insolvency proceedings in respect of the assignor. The Coeur Defense case confirmed that the notification is only a means of disclosing the transfer of the receivables to the assigned debtors and should not be characterised as an enforcement of a security interest even when the receivables are transferred by way of security. As from the date on which the debtors of the assigned receivables are properly notified in accordance with the *Loi Dailly* assignment, they can only validly discharge the corresponding debt by paying the assignee.

17. Japanese CMBS market – the story so far...

In the run up to the credit crisis in 2008, the Japanese CMBS market experienced a period of record activity that reached its peak in 2007. As was the case for CMBS markets around the world, the Japanese CMBS market was not spared by the credit crisis of 2008.

The dearth of funding put an end to new transactions and the subsequent deterioration of the state of the Japanese economy put existing transactions under significant stress. Sponsors are now faced with falling property values on one hand and limited refinancing opportunities on the other due to persistently difficult funding conditions.

This article looks at how parties to existing Japanese CMBS transactions have been dealing with the impact of falling property valuations. Although the observations are made from the perspective of Japanese law and market practice, they should provide useful guidance to parties in similar situations in other jurisdictions.

With valuations continuing to fall around the world, restructuring solutions remain limited including in Japan. A developing theme in the Japanese CMBS market is a structure which enables the parties to avoid a fire sale of the assets, hence allowing for maximum recovery through an orderly sale of assets. One such structure is to amend the loan documents in order to introduce an asset disposal and amortisation schedule together with an extension of the maturity date in a commercially acceptable timetable for an orderly disposal of assets. The lender usually has control over the sale price and identity of any buyer, although it is not uncommon to see an asset manager with a strong bargaining position retain some control over that process. Proper financial incentives for the asset manager are important if the lender intends to rely on the asset manager to carry out the asset disposal plan. Therefore, LTV breaches are usually waived in these circumstances to allow for funds to flow through to pay the disposal and incentive fees to the asset manager. This proposed structure could also work for securitised deals, however any actions of the lender or asset manager may be restricted by bondholder instructions. Any waivers or proposed amendments to the loan documents, for example, will also typically require bondholder consent.

A lender with sufficient resources and the relevant licence to perform asset management may choose to terminate the asset management agreement and take over the functions of the asset manager or appoint a new asset manager to carry out the asset disposal plan (although it is unlikely that a CMBS issuer would have these resources or a licence). The advantage in doing this is to remove a potentially uncooperative party from the transaction so as to facilitate enforcement and to avoid paying unnecessary asset management fees. A lender should be wary as to whether there are sufficient legal grounds to terminate the asset management agreement. For instance, an LTV breach may not constitute an event of default which is often the event giving rise to the lenders' right to terminate the asset management agreement. A lender is likely to be exercising its rights to terminate the asset management agreement under the terms of the security that has been granted over the asset management agreement and these terms may contain grace and cure periods in respect of any termination.

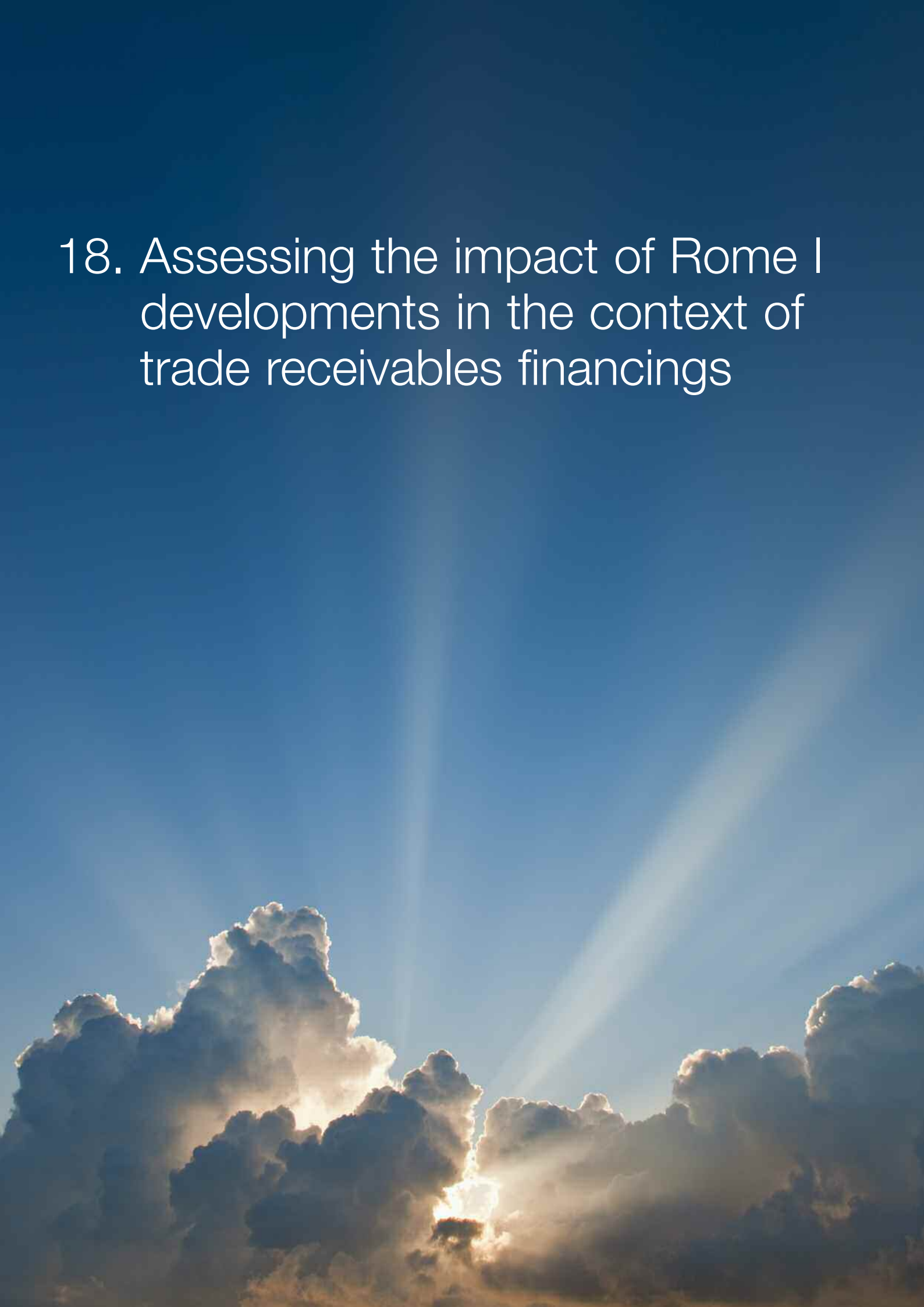
Where a lender needs to enforce its security, the most common solution is to require the borrower to sell the property voluntarily to a third party buyer identified by and on terms approved by the lender. Other alternatives include foreclosure or requiring the borrower to sell the property to the lender and setting off the outstanding loan amount. These require the lender to take the asset on to its balance sheet which is often an unpopular option or indeed a legal or regulatory impossibility for that particular lender. These are also unpopular options for securitisation issuers.

In Japan, as in other CMBS markets, CMBS loan assets often have a mezzanine piece which is held by another lender. The rights of the mezzanine lender as against the senior lender have to be examined carefully as these may range from (i) a relatively weak mezzanine position where the mezzanine lender has little more than a six to nine month mezzanine administration period and a right to cure through to (ii) a significantly stronger position where it has veto rights to a wide range of amendments, consents and waivers, including the introduction of an amortisation schedule for the senior loan or the replacement of the asset manager. In such circumstances, the risk of deadlock in negotiations can be significant if the mezzanine position has already suffered total or close to total loss.

An interesting development since the summer of 2009 is the appetite of investors to refinance the mezzanine piece, thereby removing any risk of deadlock. Such investors would structure something with limited downside, such as a loan instrument at the mezzanine level with high yielding and possibly payment-in-kind (PIK) coupon, and an equity kicker to allow them to reap the upside if there is a recovery in the property market during the term of the restructured financing.

As the maturities of Japanese CMBS loom and existing transactions come under increasing stress, we expect that more restructurings and enforcements will be carried out by the lenders themselves. The appearance of new investors is an encouraging sign for the market as the distressed situation and falling valuations are interpreted by some as an opportunity to enter (or to re-enter) the market.

18. Assessing the impact of Rome I developments in the context of trade receivables financings



From 17 December 2009, Rome I[1] has replaced the Rome Convention[2] in determining the governing law of contracts.

This article examines the changes that Rome I has brought about from the perspective of secured lenders involved in trade receivables financing, before examining the concerns of the markets and considering what the changes mean for commercial entities on a practical level.

The Rome Convention

The Rome Convention has generally been a success because of its emphasis on freedom of choice. It protected weaker parties, such as employees and consumers, but most commercial parties were given the freedom to choose the law they wanted to govern their contracts. Where the parties have not chosen the applicable law, the Convention provides that a contract is governed by the law of the country with which it is most closely connected, which it presumes to be the law of the habitual residence of the party which is to effect the performance characteristic of the contract.. This presumption as to the governing law is rebuttable – meaning a party could seeking to argue that another governing law should apply.

Changes under Rome I

The Commission's proposal for the Rome I Regulation (the "Regulation") included significant changes to the text of the Rome Convention. The Commission had not consulted on the changes, and, further, refused to conduct an impact assessment on their effect because, it asserted, they were only minor and would have little impact. This led to two years of wrangling over the Regulation. However, the final form of Rome I broadly has the same effect as the Rome Convention. Crucially, parties are still largely free to adopt a governing law of their choice and rules apply to determine the implied governing law if no governing law is selected in the contract.

Impact on trade receivables financing

In most trade receivables financings where receivables are assigned by the originating entity to the financier or a special purpose company, the governing law of the assignment will be the law expressly chosen in the assignment contract, unless the contract impacts on a limited range of legal issues, such as certain mandatory law provisions or the contract involves consumers, which is unlikely. However, the law governing the contract creating the receivables (the "debt contract") between the obligor and the assignor may not have been expressly chosen. In the event that no express choice of governing law is made, Rome I has made the process of determining which law is most closely connected to a contract more straightforward as eight rules have been included to indicate which will be the relevant law for specified types of contracts.. These changes increase the clarity of the provisions and therefore increase the predictability of the regulation's application.

If no express chose of law is made, unless another governing law is proved to be more closely connected to the contract, then the governing law of the debt contract will be that of the jurisdiction in which the seller of goods or supplier of services has their habitual residence. For companies this will be the location of the principal place of business.

To illustrate the application of these rules, if a seller of goods is based in Germany this will create a presumption that German law is the governing law of the agreement under which the goods are sold, and only if another governing law is obviously more appropriate would German law not apply.

The law governing the debt contract will also be relevant as lenders will wish to perform due diligence on these contracts to ensure that the receivable has been validly created and that the receivable will be validly assigned. The governing law of the debt contract will determine whether the relevant claim has been validly assigned, as well as establish the relationship between the assignee and debtor (including the conditions under which such assignment can be invoked against the debtor or whether the debtor's obligations have been validly discharged). This applies to transfers of claims by way of security and pledges as well as outright transfers. It is possible that the governing law of the debt contract and the governing law of the assignment will be different, although in securitisation-type trade receivables financing they tend to be the same.

Confusingly, a third law may be relevant as the law governing priority as between successive assignees and the law governing the effectiveness of an assignment against third parties has not been provided for in Rome I, although Rome I does provide for a review of these provisions to be completed by 17 June 2010. In advance of this deadline, Member States have been consulting

[1] Regulation (EC) No. 593/2008 of 17 June 2008

[2] Convention on the Law Applicable to Contractual Obligations of 1980

with industry and, in the United Kingdom, the Ministry of Justice has been consulting on two proposals namely, using the law of the habitual residence of the assignor or using the law of the debt contract. Clifford Chance's Structured Debt Group responded to these proposals and supported the law of the debt contract being the law governing priorities and effectiveness of an assignment against third parties. Our consultation response has been made public, however, in summary, the priority of competing assignees is not relevant to trade receivables financing structures or other securitisation structures because the rating agencies permit certain assumptions to be made in the legal opinion analysing the legal risks in a particular securitisation transaction. Typical permitted assumptions are that the parties will comply with their obligations under the transaction documents and that there will be no fraud. These assumptions, read together with a typical covenant by the originator not to assign the receivables to any person other than as set out in the transaction documents, removes the determination of the priority of assignments from the analysis of the legal risks of a particular securitisation transaction.

The law governing the effectiveness of the assignment against third parties will be relevant to trade receivables financing and securitisation structures and, as the law of the debt contract is already subject to due diligence for the purposes of the "true sale" opinion, we support the proposition that the law of the debt contract should also govern the effectiveness of the assignment against third parties. We have concerns that the law of the habitual residence of the assignor may change and/or may be difficult to determine. Furthermore, it may result in an additional 'third' law being relevant to the effectiveness of the receivables assignment potentially creating conflicts of law issues and decreasing legal certainty.

Conclusion

Trade receivables financiers will welcome the freedom to choose the governing law of the assignment contract being preserved in Rome I. However, the industry will be watching the outcome of the negotiations between Member States with respect to the law governing the effectiveness of assignments against third parties.

Clifford Chance contacts (London)

To discuss any of the issues in this publication, please contact one of our market experts below:

Structured Debt

Claude Brown
Partner, London
T: +44 20 7006 1447
M: +44 78 8158 8716
E: claude.brown@cliffordchance.com

Matthew Cahill
Partner, London
T: +44 20 7006 5048
M: +44 78 7658 2847
E: matthew.cahill@cliffordchance.com

Steve Curtis
Partner, London
T: +44 20 7006 2281
M: +44 77 1754 2517
E: steve.curtis@cliffordchance.com

Andrew Forryan
Partner, London
T: +44 20 7006 1419
M: +44 77 8570 0123
E: andrew.forryan@cliffordchance.com

Neil Hamilton
Partner, London
T: +44 20 7006 2081
M: +44 77 1754 2679
E: neil.hamilton@cliffordchance.com

Kevin Ingram
Partner, London
T: +44 20 7006 2416
M: +44 77 8529 6111
E: kevin.ingram@cliffordchance.com

Rachel Kelly
Partner, London
T: +44 20 7006 2559
M: +44 77 7058 6075
E: rachel.kelly@cliffordchance.com

Jessica Littlewood
Partner, London
T: +44 20 7006 2692
M: +44 79 1988 0907
E: jessica.littlewood@cliffordchance.com

Emma Matebalavu
Partner, London
T: +44 20 7006 4828
M: +44 79 0016 7181
E: emma.matebalavu@cliffordchance.com

Prashanth Satyadeva
Partner, London
T: +44 20 7006 2817
M: +44 77 4008 4372
E: prashanth.satyadeva@cliffordchance.com

Peter Voisey
Partner, London
T: +44 20 7006 2899
M: +44 77 1754 2816
E: peter.voisey@cliffordchance.com

Corporate Trusts

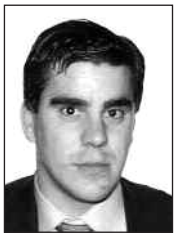
Esther Cavett
Partner, London
T: +44 20 7006 2847
M: +44 77 7591 1251
E: esther.cavett@cliffordchance.com

Susan Rose
Partner, London
T: +44 20 7006 2385
M: +44 77 7591 1285
E: susan.rose@cliffordchance.com

Clifford Chance contacts (Global)

Structured Debt

Lewis Cohen
Partner, New York
T: +1 212878 3144
M: +917 446-5727
E: lewis.cohen@cliffordchance.com



Jose Manuel Cuenca
Partner, Madrid
T: +34 91590 7535
M: +34 659779911
E: josemanuel.cuenca@cliffordchance.com

Lounia Czupper
Partner, Brussels
T: +32 2533 5987
M: +32 496239987
E: lounia.czupper@cliffordchance.com

Debashis Dey
Partner, Dubai
T: +971 43620 624
M: +971 506507117
E: debashis.dey@cliffordchance.com

David Felsenthal
Partner, New York
T: +1 212878 3452
M: +1 6463292676
E: david.felsenthal@cliffordchance.com

Frank Graaf
Partner, Amsterdam
T: +31 20711 9150
M: +31 621238601
E: frank.graaf@cliffordchance.com

Arthur Iliev
Partner, Moscow
T: +7 495258 5021
M: +7 4957632492
E: arthur.iliev@cliffordchance.com

Steve Jacoby
Partner, Luxembourg
T: +352 485050 219
M: +352 621303470
E: steve.jacoby@kremer.cliffordchance.com

Dr. Arne Klüwer
Partner, Frankfurt
T: +49 697199 3932
M: +49 1757290352
E: arne.kluewer@cliffordchance.com

Steven Kolyer
Partner, New York
T: +1 212878 8473
M: +1 6319484800
E: steven.kolyer@cliffordchance.com

Tineke Kothe
Partner, Amsterdam
T: +31 20711 9146
M: +31 655798941
E: tineke.kothe@cliffordchance.com

Christian Kremer
Managing Partner, Luxembourg
T: +352 485050 201
M: +352 621148189
E: christian.kremer@kremer.cliffordchance.com

Oliver Kronat
Partner, Frankfurt
T: +49 697199 4575
M: +49 1605309086
E: oliver.kronat@cliffordchance.com

Frédérick Lacroix
Partner, Paris
T: +33 14405 5241
M: +33 688144673
E: frederick.lacroix@cliffordchance.com

Leng-Fong Lai
Partner, Tokyo
T: +81 35561 6625
M: +81 8013859804
E: leng-fong.lai@cliffordchance.com

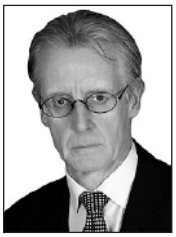
Jonathan Lewis
Partner, Paris
T: +33 14405 5281
M: +33 687752499
E: jonathan.lewis@cliffordchance.com

Gareth Old
Partner, New York
T: +1 212878 8539
M: +1 917 744 0693
E: gareth.old@cliffordchance.com

Simeon Radcliff
Partner, Moscow
T: +7 495 725 6415
M: +7 985 410 4159
E: simeon.radcliff@cliffordchance.com

Peter Scherer
Partner, Frankfurt
T: +49 697199 1294
M: +49 1709222872
E: peter.scherer@cliffordchance.com

Tanja Svetina
Partner, Milan
T: +39 0280634 375
M: +39 3478090025
E: tanja.svetina@cliffordchance.com



Frederick Utley
Partner, New York
T: +1 212878 8356
M: +1 6463292744
E: frederick.utley@cliffordchance.com

Kirti Vasu
Partner, Frankfurt
T: +49 697199 3252
M: +49 1729683087
E: kirti.vasu@cliffordchance.com

Robert Villani
Partner, New York
T: +1 212878 8214
M: +1 646 385 6163
E: robert.villani@cliffordchance.com

Christopher Walsh
Partner, Abu Dhabi
T: +971 2 4102 520
M: +971 50 6507 422
E: christopher.walsh@cliffordchance.com

Pieter van Welzen
Partner, Amsterdam
T: +31 20711 9154
M: +31 650285809
E: pieter.vanwelzen@cliffordchance.com

Daniel Zerbib
Partner, Paris
T: +33 14405 5352
M: +33 610283459
E: daniel.zerbib@cliffordchance.com

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Richard Blewett

Timothy Cleary

Stefan Erasmus

Esther Griffioen

Vincent Hatton

Anne Janert

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Robert Masman

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Catherine Overton

Marie-Isabelle Palacios-Hardy

James Pedley

Michelle Savage

Kerstin Schaepersmann

Johanna Sheppard

Jane Son

Anne Tanney

Beda Wortman

Maggie Zhao

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