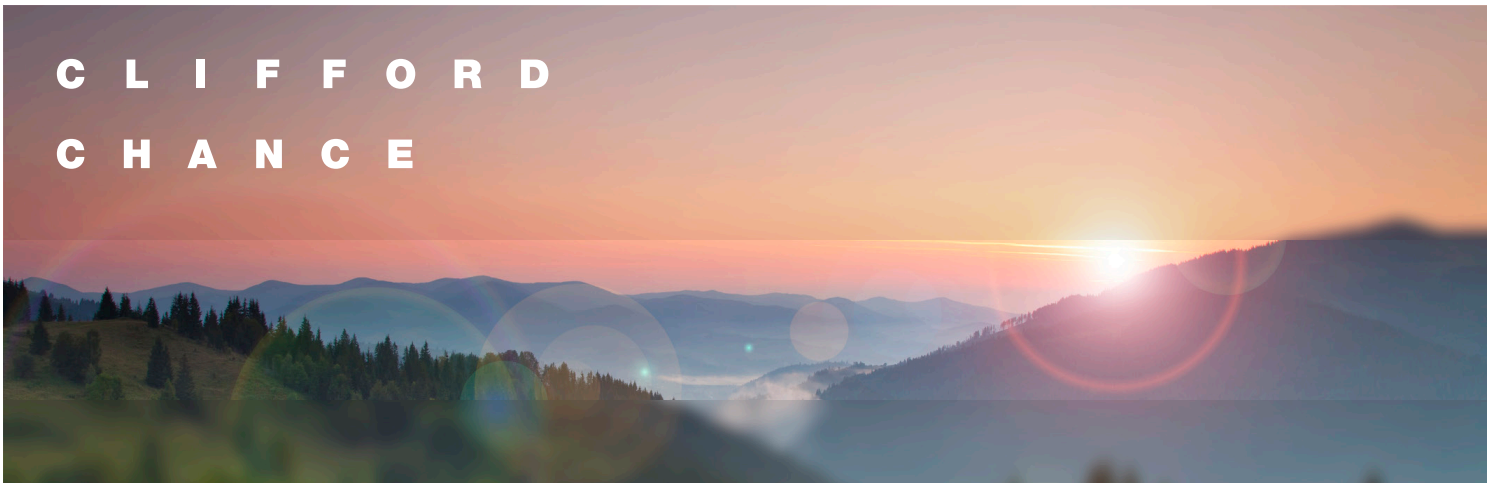

FUNDS AND SECURITISATION: WHAT DOES THE FUTURE HOLD FOR ASSET MANAGERS?

There has been relatively little change in the securitisation regulatory landscape for asset managers over the past couple of years. Asset managers have faced some challenges and uncertainties around interpretation of the scope of the EU Securitisation Regulation ("**EUSR**"), as it applies to alternative investment fund managers ("**AIFMs**"), including non-EU AIFMs and small AIFMs in particular. In the absence of interpretative guidance, AIFMs have necessarily had to take a view on how these rules apply to them today, leading to a fairly settled position across the market. However, in recent months, there have been a number of indications that changes are on the horizon both at EU level and in the UK. In this article, we review the recent and upcoming changes to the regulatory framework for securitisation as it relates to funds.

This article is part of a series that will be published in our "Structured Debt in a New World" publication launching early 2022. The publication will cover hot topics in the structured debt market such as this one.

General background

In the EU, the European Supervisory Authorities ("**ESAs**") published an Opinion in March 2021 on the jurisdictional scope of application of the EUSR, recommending that existing uncertainties are clarified as part of the ongoing reviews of both the EUSR and Alternative Investment Fund Managers Directive ("**AIFMD**"). However, the European Commission's proposal to amend AIFMD published on 25 November 2021 does not directly address this issue. While the ESAs Opinion generally seems in line with existing market interpretations on the application of the EUSR to third country AIFMs, fund managers will still need to monitor how these uncertainties may be clarified in final rules (for example in case amendments are introduced as the AIFMD proposal makes its way through the EU legislative process or as part of the expected EUSR review proposal). It is also not yet clear whether or how potential application of due diligence requirements under EUSR to small AIFMs may be addressed, as again this was not included in the recently published AIFMD review proposal.

In the UK, HM Treasury has also consulted on its review of the Securitisation Regulation, including potential changes to limit the extraterritorial impact of the institutional investor definition to exclude non-UK AIFMs. This would reinstate the pre-Securitisation Regulation position for third country AIFMs and is likely to be a welcome change for the industry in a post-Brexit world, where overlapping EU and UK regulatory requirements have increased the compliance burden for asset managers doing business across the UK and EU.

Looking further ahead, fund managers should also start to consider the potential impact of the new EU Directive on Credit Servicers and Credit Purchasers ("**NPL Secondary Markets Directive**") on non-performing loan ("**NPL**") securitisations, and indeed the secondary market for NPLs more broadly. The new Directive forms part of the EU's action plan to tackle non-performing loans and will introduce new requirements on firms that purchase or are appointed to service NPLs, including in the context of securitisations.

While the new Directive ostensibly aims to help EU banks transfer NPLs off their balance sheets by introducing a harmonised regime for credit purchasers and servicers across the EU, it will also impose new due diligence, reporting and other information requirements, which may give rise to additional challenges and frictions. Nevertheless, given that parties to NPL securitisations already need to comply with extensive due diligence requirements under the EUSR, the NPL securitisation market may be better placed to implement and comply with the requirements of the NPL Secondary Markets Directive than other areas of the secondary loan market. Therefore, we expect the NPL Secondary Markets Directive may serve to reinforce the benefits of securitisations as a method for EU banks to transfer NPLs off their balance sheets overall. The deadline for EU Member States to transpose and apply these new requirements is 24 months after publication in the EU Official Journal (currently expected around the end of 2021 or early 2022).

The recently published AIFMD review proposal also adds loan origination activities and servicing securitisation SPVs to the list of permitted activities for authorised AIFMs, to clarify that these are legitimate activities for AIFMs to carry on and to harmonise the ability of EU AIFs to originate loans in the EU, including on a cross-border basis.

ESAs Opinion on jurisdictional scope of the EUSR

When the EUSR replaced the pre-existing securitisation provisions under the AIFMD in 2019, it raised questions about the jurisdictional scope of the regime and how the requirements of the Securitisation Regulation apply particularly in respect of non-EU alternative investment fund managers ("**AIFMs**") and the funds they manage ("**AIFs**"). In the absence of official guidance or clarification on these issues, the industry has needed to operate on the basis of reasonable interpretations of the rules.

However, in March 2021, the ESAs published an Opinion acknowledging these areas of uncertainty and recommending that they are clarified as part of the ongoing reviews of both the EU Securitisation Regulation and AIFMD. While the ESAs Opinion generally seems in line with existing market interpretations, fund managers will still need to monitor how these uncertainties are clarified in final rules.

"Institutional investor" definition: application to non-EU AIFMs

The ESAs Opinion highlights potential inconsistencies between the definition of "institutional investor" under the EUSR and the obligations under Article 17 AIFMD for EU-authorised AIFMs to take "corrective action" in respect of exposures to non-compliant securitisations.

The definition of "institutional investor" in the EUSR includes an AIFM as defined in Article 4(1)(b) AIFMD that manages and/or markets an AIF in the EU. The definition of

an AIFM under Article 4 AIFMD is not geographically limited and therefore this appears to capture non-EU AIFMs marketing AIFs in the EU.

This is broader than the pre-EUSR position, which imposed relevant requirements under Article 17 AIFMD only on EU-authorised AIFMs managing AIFs in the EU. However, the real question the market had to contend with in 2019 was whether or not this brought non-EU AIFMs into scope only with respect to the AIFs they marketed in the EU, or whether marketing a single AIF in the EU would bring the non-EU AIFM into scope with respect to all of its funds (even those not marketed in the EU).

Helpfully, the ESAs clarify in their Opinion that, in their view, non-EU AIFMs marketing AIFs in the EU should be considered institutional investors only with respect to the AIF(s) being marketed in the EU. We understand this is in line with interpretations that have generally been taken in the market on this point.

However, neither EUSR nor AIFMD currently sets out how non-EU AIFMs should be supervised for compliance with these requirements, including which national regulator(s) would be responsible for supervision in the case of non-EU AIFMs marketing AIFs in the EU. Following the ESAs Opinion, it is somewhat surprising that these questions have not been addressed as part of the Commission's proposed amendments to AIFMD published in November 2021. However, it is possible that the European Parliament or Council may propose further amendments that seek to clarify these points as the AIFMD review proposal makes its way through the EU legislative process, or that clarifications may be proposed as part of upcoming proposals to amend the EUSR. Alternatively, if formal amendments are not made to the AIFMD or EUSR on these points, the industry may continue to rely on established interpretations and/or relevant EU guidance such as the ESAs Opinion or Q&A.

"Institutional investor" definition: application to sub-threshold AIFMs

The ESAs Opinion also considers whether sub-threshold AIFMs are caught by the definition of "institutional investor". The ESAs note there is no explicit carve out from the definition of institutional investor for sub-threshold AIFMs, even though sub-threshold AIFMs are generally exempt from most requirements under AIFMD. In the Opinion, the ESAs do not express a clear view as to whether they consider sub-threshold AIFMs should be exempt from the EUSR requirements on institutional investors. Instead, they recommend that the position is clarified as part of the ongoing AIFMD review, which is looking at what requirements should apply to sub-threshold AIFMs more broadly.

In the meantime, the position remains unclear, although again neither EUSR nor AIFMD currently includes a framework for national regulators to supervise sub-threshold AIFMs for compliance with these requirements, if they were considered to apply. In the event that the AIFMD review concludes that sub-threshold AIFMs should remain out of scope of EUSR requirements (which appears to be the case from the Commission's recently published AIFMD review proposals), changes to the definition of "institutional investor" in the EUSR may also be needed to clearly reflect this.

Article 5(5) EUSR and ability to delegate due diligence

The obligations on institutional investors include requirements to carry out extensive due diligence prior to holding a securitisation position under Article 5 EUSR (unless the institutional investor is also the originator, sponsor or original lender). However, where the institutional investor has given another institutional investor authority to make investment management decisions that might expose it to a securitisation, Article 5(5) EUSR provides that the institutional investor can also delegate responsibility to perform this due diligence.

Importantly, Article 5(5) EUSR provides that this delegation to another institutional investor absolves the first institutional investor of regulatory responsibility to perform the due diligence itself – in contrast to usual principles of delegation, for example under AIFMD, where the delegating party retains regulatory responsibility for relevant obligations and is required to oversee its delegate's performance of those obligations).

The Opinion highlights this potential discrepancy between EUSR and AIFMD, although the exception to the general AIFMD delegation position is justified by virtue of the fact that a direct regulatory obligation is then placed on the delegate to comply with the Article 5 due diligence requirement. This is another reason why it is important for the uncertainties in the definition of "institutional investor" to be clarified, to determine whether or not an institutional investor retains responsibility for due diligence where it appoints a non-EU AIFM or sub-threshold AIFM as its delegate.

HM Treasury Call for Evidence on the UK Securitisation Regulation

HM Treasury is also consulting on its review of the UK Securitisation Regulation ("**UKSR**") in a call for evidence published in June 2021. Like the ESAs' Opinion, HM Treasury highlights the extraterritorial impact of the current definition of institutional investor on non-UK AIFMs.

However, HM Treasury proposes taking action to narrow the territorial scope of the definition of institutional investor to take certain unauthorised, non-UK AIFMs out of scope of the due diligence requirements under the UKSR. HM Treasury highlights that the extraterritorial application of due diligence requirements to non-UK AIFMs marketing AIFs in the UK poses potential challenges for supervision and enforcement, as such firms are likely to be outside the scope of the Financial Conduct Authority's ("**FCA**") regulatory jurisdiction.

In addition, HM Treasury notes that other non-UK institutional investors are not required to comply with due diligence requirements under the UKSR, and so the position of non-UK AIFMs is unique in this regard. Finally, HM Treasury considers it may be disproportionate to apply UKSR due diligence requirements to non-UK AIFMs and it could disincentivise them from seeking investors in the UK, potentially impacting the competitiveness of the UK's financial market.

HM Treasury is seeking views on this proposed narrowing in scope of the definition of institutional investors to take certain unauthorised, non-UK AIFMs out of scope via its call for evidence, which closed on 2 September 2021. However, the call for evidence

does not expressly address the point about whether small, registered UK AIFMs should be captured within the definition of "institutional investor". This is an issue which market participants may nevertheless raise their responses to the call for evidence and so it may be considered further in the next stages of the UK government's review of the UKSR, on which a report is due to be laid before Parliament by 1 January 2022.

NPL Secondary Markets Directive impact on fund managers

Looking further ahead, the text of the new NPL Secondary Markets Directive has now been agreed, although its requirements are not expected to apply until the end of 2023 or early 2024. Nevertheless, it is worth taking note of the changes expected to be introduced under the Directive now, in order to anticipate and plan for how these requirements may impact investors in secondary NPL transactions and the structuring of those transactions, including NPL securitisations.

The NPL Secondary Markets Directive will introduce new EU-wide requirements on the secondary purchase and servicing of NPLs originated by EU banks. In-scope credit servicers will require authorisation in order to carry on their servicing activities, but they will also benefit from a new passporting regime allowing them to scale up activities across the EU. In-scope credit purchasers will not require authorisation, but they will need to appoint an authorised credit servicer (or an EU bank or creditor that is subject to supervision under the EU Consumer Credit Directive or Mortgage Credit Directive) where they acquire consumer NPLs (or natural person or SME NPLs, in the case of non-EU credit purchasers). Non-EU credit purchasers will also need to appoint an EU representative that will be responsible for compliance with the requirements of the NPL Secondary Markets Directive on behalf of the third country credit purchaser. This can be the same entity as their credit servicer.

Scope of the NPL Secondary Markets Directive

The NPL Secondary Markets Directive applies in respect of the secondary transfer of NPLs or the rights under NPLs originated by an EU bank to a transferee other than another EU bank (the "**credit purchaser**"). Transfers of performing loans are out of scope; for this purpose, NPLs are defined by reference to Article 47a CRR.[1] In addition, transfers of NPLs originated by entities other than EU banks are out of scope, although national rules and restrictions on transfers of such NPLs may apply.

The NPL Secondary Markets Directive also regulates "credit servicing activities", which it defines as the collection or recovery of payments from borrowers, renegotiating terms and conditions with borrowers, dealing with complaints and/or informing borrowers about changes to interest rates, charges or payments due. Legal entities that carry out these activities on behalf of credit purchasers in scope of the NPL Secondary Markets Directive will generally require authorisation as a credit servicer. (It is also open to EU Member States to allow credit purchaser to appoint natural persons to carrying on credit servicing activities, but they will not benefit from the EU-wide authorisation and passporting regime for credit servicers.)

1 Capital Requirements Regulation (EU) No 575/2013

However, the credit servicing requirements of the NPL Secondary Markets Directive do not apply to credit servicing activities carried out by EU credit institutions, authorised or registered AIFMs, UCITS management companies or entities that are subject to supervision in the relevant Member State under the EU Consumer Credit Directive or Mortgage Credit Directive. This means that EU AIFMs and UCITS management companies may themselves carry out credit servicing of NPL portfolios purchased by the funds they manage. However, MiFID portfolio managers or (other) delegates of an EU AIFM or UCITS management company do not benefit from a similar carve out from the scope of the NPL Secondary Markets Directive and so they would not be permitted to carry on credit servicing activities themselves (unless they were to obtain further authorisation as a credit servicer).

EU Member States can also continue to regulate other forms of credit servicing at national level, such as the servicing of loans originated by non-bank lenders.

While an exclusion from scope for NPL securitisations had been proposed during the negotiation process of the NPL Secondary Markets Directive, this is not included in the final text. Instead, there is a limited provision indicating that the NPL Secondary Markets Directive "shall not affect requirements in Member States' national laws" regarding credit servicing where the credit purchaser is a securitisation special purpose entity (as defined in the EUSR) provided that such national laws: (i) do not affect the level of consumer protection provided by the Directive; and (ii) ensure that competent authorities receive the necessary information from credit servicers. In practice, this means that most requirements of the NPL Secondary Markets Directive are expected to apply to NPL securitisations, with the exception of information requirements, as discussed below.

Information requirements for secondary transfers of NPLs and EBA templates

Where funds or other prospective purchasers are looking to purchase NPLs from an EU bank, the bank selling the NPLs will need to provide sufficient information (proportionate to the nature and size of the NPL portfolio being sold) to enable the proactive purchaser to diligence the relevant NPLs. The EBA is required to develop technical standards on the format in which this information is to be provided, in respect of in respect of any in-scope, subject to some transitional provisions for legacy loans. The EBA has already done significant work in this area, having published a Discussion Paper in May 2021, and will presumably use its existing templates as a base for the technical standards it has to develop under the NPL Secondary Markets Directive.

However, the recitals to the NPL Secondary Markets Directive indicate that where securitisation-related templates also need to be completed under the EUSR, double reporting of information should not be required under the NPL Secondary Markets Directive. Therefore, in practice, it is possible that most information for NPL securitisations would continue to be provided under the securitisation-specific templates, but this would require some further action (e.g. in the EBA's forthcoming technical standards) since there is no operative implementation of this principle in the NPL Secondary Markets Directive itself.

Appointment of a credit servicer – credit servicing agreement

Another new requirement under the NPL Secondary Markets Directive relates to the terms of appointment of a credit servicer. Where a fund or other credit purchaser appoints a credit servicer to carry on credit servicing activities, the parties are required to enter into a credit servicing agreement. This agreement must include:

- a detailed description of the credit servicing activities to be carried out,
- terms on the credit servicer's remuneration,
- the extent to which the credit servicer can represent the credit purchaser in relation to the borrower,
- an undertaking by the parties to comply with applicable law relating to the credit agreement itself, including in respect of consumer and data protection,
- a clause requiring the fair and diligent treatment of borrowers, and
- a requirement for the credit servicer to notify the credit purchaser before outsourcing any of its credit servicing activities.

It is not clear whether Member States may also seek to apply these requirements to situations where a credit purchaser appoints an EU bank or entity supervised under the CCD or MCD (such as the original lender) to service the credit agreements.

Other information and reporting requirements

The NPL Secondary Markets Directive includes various other information and reporting requirements. In particular:

- Following an NPL transfer, the credit purchaser or credit servicer (if one has been appointed) is required to inform the borrower(s) of the transfer, including the date of the transfer and identity of the credit purchaser (and if relevant the credit servicer). This information must be provided before the first debt collection and whenever the borrower requests it. This would represent a significant change from current market practice for NPL securitisations, where borrowers are often unaware that their loans have been transferred or securitised.
- EU banks and credit purchasers who onward-sell NPLs must supply data on their sales of NPLs to their regulators bi-annually (or quarterly if requested). This data must include details of the purchaser(s) and aggregated borrower data. If the NPLs include consumer loans, additional data must also be provided.

Next steps

The NPL Secondary Markets Directive is expected to be published in the Official Journal around the end of 2021 (or early 2022). EU Member States will then have 24 months transpose and apply its requirements. While the Directive seeks to harmonise certain key aspects of secondary NPL transfers and servicing, it also leaves various options and discretions to Member States, such as whether to regulate transfer and servicing of credit agreements that fall outside the scope of the Directive. Therefore, it will be important to monitor the way that Member States seek to transpose and implement these requirements.

Conclusion

After a few years of relative stability in the EU and UK regulatory landscape for asset managers engaging in securitisations, various new developments are now on the horizon. The clarifications to the scope of the institutional investor definition under the EUSR are unlikely to have a significant practical impact on firms, given that the ESAs Opinion appears to broadly accord with current industry interpretations. The potential narrowing of the territorial scope of the UK institutional investor definition should serve to reduce the overlap between UK and EU rules, which is likely to be welcomed in the post-Brexit context where firms are often left grappling with two sets of very similar (but not quite identical) rules.

The NPL Secondary Markets Directive will likely bring some implementation challenges for asset management firms, particularly if different Member States take different approaches to implementation or gold-plate its requirements where they are permitted to do so. New information and reporting requirements go beyond what is currently required under the Securitisation Regulation, although the increased burden is likely less extreme than for other types of secondary loan transfers, which are often unregulated today. Asset managers may also need to consider how best to navigate the credit servicer regime and related carve outs which apply to EU AIFMs and UCITS managers, but not to MiFID portfolio managers (although of course such considerations will fall away if the original lender continues to service the NPL portfolio in practice).

It will be interesting to see how the NPL securitisation market evolves to take account of the new NPL Secondary Markets Directive more broadly, for example whether existing specialist credit servicers seek to take advantage of the new passporting regime in order to provide their services throughout the EU. For further discussion of current market practice and emerging trends in NPL securitisations, including as a result of the NPL Secondary Markets Directive, see our separate article on the NPL secondary market in “Structured Debt in a New World”, due to be published in early 2022.

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