IMPACT OF THE SECURITISATION REGULATION ON UCITS FUNDS

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Introduction

On 17 January 2018 the new Securitisation Regulation (Regulation EU 2017/2402) (the "Securitisation Regulation") came into force and will apply from 1 January 2019. The Securitisation Regulation represents a long-awaited reform of the EU securitisation rules which will replace the existing patchwork of sector-specific legislation governing European securitisations with harmonised rules on due diligence, risk retention and transparency applying to all securitisations.

Over the last number of years, there has been an emerging trend from investment managers focussed on credit seeking exposure to securitisations located in the US, Cayman Islands and Europe with underlying credit exposure to European and US assets through UCITS. Such securitisations are typically structured as collateralised loan obligations (colloquially referred to as "CLOs"), collateralised debt obligations or collateralised mortgage applications. The introduction of the Securitisation Regulation is a significant change for investment managers who manage UCITS which take exposure to securitisations.

The challenge facing investment managers of UCITS is to ensure the investment universe of securitisations to which they intend to take exposure are eligible for UCITS investment and that the securitisations also enable UCITS to comply with the new obligations under the Securitisation Regulation. For the purposes of this article, we have set out the impact on UCITS and the new obligations which will be imposed upon them under the Securitisation Regulation.

What is a Securitisation?

A "securitisation" is, broadly speaking, a transaction or scheme, whereby credit risk is tranched and the payments are dependent upon the performance of the exposure or pool, the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or the transaction does not create exposures which, amongst other items, give the lender a substantial degree of control over the assets and the income that they generate.

The definition of securitisation has its origins in the Capital Requirements Regulation ("CRR") which is reaffirmed in the Alternative Investment Fund Managers Directive ("AIFMD") and has been replicated in the Securitisation Regulation.

What is the Impact for UCITS?

Currently the risk retention obligations set down under the CRR and AIFMD applies to credit institutions, insurance companies and to EU alternative investment fund managers ("AIFMs"), respectively. From 1 January 2019, the Securitisation Regulations broadens the application of the risk retention requirements to UCITS management companies and internally managed UCITS (together with credit institutions, insurance companies and AIFMs, the "Institutional Investors").

Accordingly, on or before 1 January 2019 UCITS management companies will need to ascertain whether or not the UCITS under management is exposed to any securitisations and, where it is, ensure that it complies with the due diligence, risk retention and transparency requirements under the Securitisation Regulation. The Securitisation Regulation stipulates that "where [UCITS] is exposed to a securitisation that does not meet the requirements of the Securitisation Regulation, the UCITS shall, in the best interest of the investors in the relevant UCITS, act and take corrective action".

As such, UCITS will be required to take "corrective action" in relation to its non-compliant securitisation holdings in advance of 1 January 2019. After 1 January 2019, a UCITS will be able to purchase non-compliant securitisations that were issued before 1 January 2019, but cannot purchase non-compliant securitisations issued after 1 January 2019. Should a formerly compliant securitisation issued after 1 January 2019 cease to be compliant, then the UCITS fund will be obliged to take "corrective action".

This marks a shift whereby originators, sponsors or lenders will be directly obliged to meet the requirements of the Securitisation Regulation rather than (as is currently the case under AIFMD requiring the AIFM, as the investor, to determine that the originators, sponsors or lenders have complied. The anomaly whereby UCITS were not subject to due diligence, transparency and risk retention requirements with respect to investment in securitisation positions has been rectified. Article 50a of the UCITS Directive is replaced with a new provision stating that where UCITS are exposed to securitisation positions which do not meet the requirements of the Securitisation Regulation, the UCITS shall take corrective action as noted above.

New Requirements for UCITS

The Securitisation Regulation outlines three key requirements which UCITS must adhere to, namely:

a) Due Diligence; carry out a due diligence process before becoming exposed to a securitisation and on an ongoing basis as long as they remain exposed to a securitisation;

b) Risk Retention; ensure that the securitisation is risk retention compliant with the originator retaining a material net economic interest of not less than 5% in the securitisation; and

c) Transparency and Disclosure; on an ongoing basis the originator of the securitisation must make available to holders of a securitisation position certain information on the transaction and underlying exposures.

STS Transactions

The Securitisation Regulation also introduces new rules for issuing simple, transparent and standardised securitisation transactions ("STS") which provides that Institutional Investors may rely to an "appropriate extent" on an STS notification and related information prepared by the securitising entities with respect to compliance with the Securitisation Regulation requirement.