WHITE & CASE

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The credit rating market for structured finance instruments: new requirements for issuers, originators and sponsors

On 31 May 2013, Regulation (EU) No 462/2013 (the **"Amendment Regulation"**[1]) that further amends Regulation (EC) No 1060/2009 on credit rating agencies was published in the Official Journal. This was accompanied by a short Directive (the **"Amendment Directive"**[2]) amending Directive 2003/41/EC on institutions for occupational retirement provision, Directive 2009/65/EC on undertakings for collective investment in transferable securities and the Alternative Investment Fund Managers Directive 2011/61/EU in respect of over-reliance on credit ratings.

The Amendment Regulation and Amendment Directive aim to address regulatory concerns related to the credit rating market, including over-reliance by investors and financial services firms on the risk assessments of investments provided by credit rating agencies, conflicts of interests that may affect these risk assessments and significant barriers to market entry by new credit rating agencies. However, the Amendment Regulation imposes new obligations not only on credit rating agencies but also on issuers, originators and sponsors in connection with structured finance instruments.

In particular, the following changes affect, or may affect, issuers, originators and sponsors of structured finance instruments which are established in the European Economic Area:

- an obligation on the issuer, the sponsor and the originator to publish extensive information on structured finance instruments;
- a requirement for two independent credit ratings of structured finance instruments by two credit rating agencies;
- a requirement to consider the appointment of a smaller credit rating agency when using at least two credit rating agencies; and
- mandatory rotation of credit rating agencies in relation to the rating of re-securitisations with underlying assets from the same originator.

This client alert provides an overview of these new requirements.

Most of them apply from the 20th day from the publication of the Amendment Regulation in the Official Journal, i.e. from 20 June 2013. However, the precise disclosure requirements on issuers, sponsors and originators are yet to be specified in technical standards and become applicable only at a later date. Further, ESMA has yet to publish certain information that will assist with evaluating the possibility of appointing smaller credit rating agencies.

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1 Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:146:0001:0033:EN:PDF.

2 Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:145:0001:0003:EN:PDF.

Scope and definitions

The requirements introduced by the Amendment Regulation which this client alert focuses on apply in connection with either issuances of structured finance instruments or re-securitisations. Both are defined in familiar terms, with reference to Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions.

A structured finance instrument is defined as a financial instrument or other asset resulting from a securitisation transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having the following characteristics:

a. payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; and

b. the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.

This is a very broad definition, which captures both public and private transactions. The new requirements are likely to be particularly onerous in connection with private transaction.

A re-securitisation is a securitisation where the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation position.

Disclosure of information on structured finance instruments

The issuer, the originator and the sponsor of a structured finance instrument established in the European Economic Area must, on a website set up by the European Securities and Markets Authority (**"ESMA"**), jointly publish information relating to the credit quality and performance of the underlying assets of the structured finance instrument, the structure of the securitisation transaction, the cash flows and any collateral supporting a securitisation exposure as well as any information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures. This means that a very wide range of and – especially in a private transaction context – potentially commercially sensitive information needs to be made available. The fact that disclosure is subject to applicable law governing the protection of confidentiality of information sources or the processing of personal data is unlikely to provide much practical assistance. Moreover, the information needs to be provided "*jointly*" by the issuer, the originator and the sponsor, raising practical questions about reaching consensus and managing liability risk.

The information to be published, its presentation and the frequency with which it must be updated will be further specified in regulatory technical standards. Draft regulatory technical standards will be developed by ESMA and submitted to the European Commission by 21 June 2014. These then need to be endorsed by the European Commission and are subject to a right of the European Parliament and the Council to object. In practice, the disclosure obligation cannot sensibly apply prior to the entry into force of the regulatory technical standards. In any case, the relevant information needs to be published on a website to be set up by ESMA, and this website has not yet been set up and will have to be developed in line with the technical standards.

Double credit rating of structured finance instruments

Where an issuer or a related third party intends to solicit a credit rating of a structured finance instrument, it must engage at least two credit rating agencies to obtain two independent ratings of structured finance instruments. The issuer or related third party must ensure that the appointed credit rating agencies comply with certain conditions relating to their independence. The need for a second credit rating will impose additional costs on issuers or related third parties where current market practice is to have only a single rating, as is the case with many private securitisations.

The double credit rating requirement is not stated to be subject to any regulatory technical standards. Like the majority of provisions in the Amendment Regulation, it will therefore apply from 20 June 2013 onwards. While there is no grandfathering provision in the Amendment Regulation in relation to the new double credit rating obligation, it is stated to apply only *"[w]here an issuer or a related third party intends to solicit a credit rating of a structured finance instrument".* Therefore, where a credit rating has already been assigned to a structured finance instrument prior to 20 June 2013 (and there is no change in the credit rating agency), the dual credit rating requirement will not apply.

Use of smaller credit rating agencies

Where an issuer or a related third party intends to appoint at least two credit rating agencies for the credit rating of the same issuance or entity, the issuer or related third party must consider appointing at least one credit rating agency with no more than 10% of the total market share (a **"Smaller Credit Rating Agency"**), which can be evaluated by the issuer or a related third party as capable of rating the relevant issuance or entity, provided that, based on a list to be made available by ESMA on its website, there is a credit rating agency available for rating the specific issuance or entity. Apart from the types of credit ratings issued by registered credit rating agencies, ESMA's website will also indicate their total market share to facilitate the evaluation process.

There is no obligation to actually appoint a Smaller Credit Rating Agency. However, a decision not to appoint such a credit rating agency needs to be documented.

The new requirement to consider the use of such a credit rating agency is not stated to be subject to any technical standards and it is prudent to assume that it will apply from 20 June 2013. However, at the time of writing ESMA has not yet made the additional information relating to registered credit rating agencies' market share available on its website.

Mandatory rotation of credit rating agencies

If a credit rating agency enters into a contract for the issuing of credit ratings on re-securitisations, it must not issue credit ratings on new re-securitisations with underlying assets from the same originator for a period exceeding four years. Where a credit rating agency entered into a contract for the issuing of credit ratings on re-securitisations before 20 June 2013, the relevant period must be calculated from that date.

However, where at least four credit rating agencies each rate more than 10% of the total number of outstanding rated re-securitisations with underlying assets from the same originator, this limitation does not apply. Where a credit rating agency enters into a contract for rating re-securitisations, it will request that the issuer determines the relevant number of credit rating agencies involved and the percentage of the total number of outstanding rated re-securitisations with underlying assets from the same originator each of them rates.

Credit rating agencies may in any case continue, on a solicited basis, to monitor and update credit ratings issued before the end of the maximum permitted duration of their contractual relationship.

An outgoing credit rating agency must not enter into a new contract for the issuing of credit ratings on re-securitisations with underlying assets from the same originator for a period equal to the duration of the expired contract but not exceeding four years.

None of these requirements will apply to credit rating agencies with fewer than 50 employees at group level involved in the provision of credit rating activities, or that have an annual turnover generated from credit rating activities of less than €10 million at group level.

Review

The European Commission will review the situation in the credit rating market, including in relation to structured finance instruments and re-securitisations. It will report its findings to the European Parliament and to the Council, accompanied by new legislative proposals where appropriate. Among other things, the European Commission will consider whether the scope of the disclosure obligation described above should in future be extended to other financial credit products, whether the mandatory rotation mechanism should be extended or revised in certain respects and whether sufficient choice is available to comply with the double credit rating requirement. Both the development of technical standards under the Amendment Regulation and the European Commission's review present scope for market participants to contribute to the policy development process going forward.