In Practice

Authors Jeremiah Wagner and Dan Marcus

Fund finance: the securitisation question

Does a transaction in the European fund finance market constitute a "securitisation" under EU and UK securitisation regulatory frameworks? The answer impacts the potential regulatory capital treatment and liquidity of the financing and, accordingly, the pricing that lenders may be able to provide. Funds need to be aware of this question and the regulatory implications across Europe.

An evolving theme in the proliferating European fund finance market is the express consideration during deal structuring of whether the relevant financing falls within the definition of a securitisation for the purposes of the EU[1] and UK[2] securitisation frameworks.

The question is an important one. On the lender side, whether or not the financing is a securitisation will impact regulatory capital treatment and may affect the liquidity of the securitisation position. On the manager side, the burden of the disclosure requirements and potential difficulties in finding an appropriate risk retainer have to be weighed against the typical pricing benefits. Incorrect analysis can also have severe consequences, including fines of up to 10% of annual net turnover on a consolidated basis for noncompliance, so allocation of risk and the remedies for incorrect securitisation analysis is often important even if the financing is not intended to be a securitisation.

The analysis typically begins with considering the definition of "tranche"[3] in the EU and UK securitisation frameworks. In contrast to definitions of "securitization" in US legislation, a securitisation in the EU and UK requires multiple tranches. The definition of "tranche" requires a "contractually established segment of credit risk", with the risk of credit loss associated with that segment differing from others.

The requirement for credit risk (as opposed to market or operational risk, for example) means that a securitisation is more likely to be present in asset-backed facilities to direct lending or other credit funds. However, it is possible to find and segregate credit risk for other types of facilities and other funds. For example, we have seen growing interest in (and some examples of) the addition of structural features to capital call facilities[4] to ensure that they qualify as securitisations. In such instances, the relevant credit risk is the risk that the limited partners cannot pay their commitment to the fund. This requirement can also be relevant when a debt fund invests in warrants or convertible instruments (such instruments may need to be segregated from the pool of assets to assist the relevant financing in qualifying as a securitisation) or when the fund invests in preference shares or other instruments with debt-like features.

An element of the definition of "tranche" that is a trap for the unwary is the term "contractually established". While this term would seem to exclude financings in which the equity does not take the form of debt (or another contract), the analysis often is not this straightforward. One reason is the emphasis in the recitals to the EU SECR and UK SECR on the applicability of risk retention "in all situations where the economic substance of a securitisation is applicable, whatever legal structures or instruments are used". Another reason, particularly pertinent in fund financing, is that the subordination of investors in a limited partnership is often a result of a combination of contract (the limited partnership agreement) and applicable corporate and insolvency laws. Accordingly, market participants will rarely rely on the form of the equity injected in the borrower as the sole determinant of whether a securitisation is present.

If the financing involves tranching, consideration is given to the definition of "securitisation" directly. Typically, the first limb of this definition, requiring payments in the financing to be "dependent on the performance of the exposure or of the pool of exposures", will be the key aspect in determining whether a fund financing is a securitisation. While a financing can be made to meet this requirement by providing contractually that the lenders will only have recourse to the relevant credit risks for their repayment, establishing that no such dependence exists can be more difficult. Doing so often requires substantive analysis of the other assets that are potentially and actually available to make payments in respect of the financing (it being particularly helpful if such assets are subject to risks other than credit risk and fall outside the financial covenants of the facility), or analysis of the economic incentives of other fund entities or investors to provide support to the financing (even when they are not contractually obligated to do so).

The second limb of the definition of "securitisation" will also be considered in structuring, but typically is not determinant as to whether a securitisation exists. In considering this limb, parties will look at the cash controls and any priority of payments that may apply prior to maturity or enforcement of security. The third (and final) limb is an exception to the definition and is typically not applicable in the context of fund financing, since it primarily relates to the direct financing of a physical asset.

Of course, if a fund financing constitutes a securitisation, further work is required to establish how the regulatory requirements of the EU and UK securitisation frameworks will be met. In fund financing, this may be even less straightforward than determining if a securitisation exists in the first place. ■

1 Regulation (EU) 2017/2402 (the EU Securitisation Regulation, or EU SECR).

2 Regulation (EU) 2017/2402 as retained under the domestic laws of the United Kingdom by operation of the European Union (Withdrawal) Act 2018 (as amended) (the UK Securitisation Regulation, or UK SECR).

3 Article 2(6) EU SECR and Art 2(6) UK SECR.

4 Otherwise known as bridge facilities. These are facilities that lend against security granted over the undrawn commitments of limited partners in funds.

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Jeremiah Wagner is a partner in the Finance Department of the London office of Latham & Watkins. Dan Marcus is an associate in the Finance Department of the London office of Latham & Watkins. Email: jeremiah.wagner@lw.com and dan.marcus@lw.com