Use of guarantees in supply chain finance: to be or not to be a securitisation…

Context

- On December 2021, the three European supervisory authorities (ie EBA, ESMA and EIOPA) published their answer to a question raised by a market participant.
- The answer has been added as Q6 of the "Joint Committee Q&As relating to the Securitisation Regulation (EU) 2017/2402"[1]. Answers grouped in this document are of particular importance as they express the joint position of the three ESAs (on the jurisdictional scope of the Securitisation Regulation (SR).
- The question raised by the market participant was as follows:
  - "A manufacturer sells its products to his own off takers but would like to see its invoices paid at short notice while his off takers need longer payments terms. The manufacturer and a bank agree that the bank will provide financing to a selected group of these off takers under the condition that the manufacturer provides a 15% first risk guarantee to the bank. The bank provides the loans directly to the off takers and the bank will take the loans in its lending book.
  - The definition of synthetic securitisation of Article 2(10) of Regulation (EU) 2017/2402 (SecReg) states that 'synthetic securitisation' means a securitisation where the transfer of risk is achieved by the use of credit derivatives or guarantees, and the exposures being securitised remain exposures of the originator.
  - In the structure as described above, the bank holds a pool of loans and partial transfer of credit risk is achieved via the guarantee provided by the manufacturer. The first 15% of losses on the pool will be reimbursed by the

1 See https://www.eba.europa.eu/sites/default/documents/files/document_library/About%20Us/Governance%20structure/JC/Q%26As/1025524/JC%20 2021%2019%20JCSC%20QAs%20on%20Securitisation%20Regulation%20_revised%20new%20Q6.pdf

manufacturer to the bank. Losses above the 15% will be borne by the bank.

  - It is unclear whether this kind of structure can be classified as synthetic securitisation under Article 2(10) of the EU Securitisation Regulation".

- The answer of the three ESAs was unequivocal (the "**ESA Position**"):
  - "The transaction described constitutes a securitisation within the meaning of Article 2(1) Regulation (EU) 2017/2402 (SecReg) because the credit risk associated with the pool of exposures held by the institution is tranched, the payments in the transaction are dependent upon the performance of the pool of exposures and because it does not meet the characteristics listed in Article 147(8) of Regulation (EU) No 575/2013 applicable to specialised lending.
  - The transaction also constitutes a synthetic securitisation within the meaning of Article 2(10) SecReg because the tranching is achieved by means of a guarantee under which the manufacturer has to reimburse the first 15% of losses on the pool to the institution and losses above the 15% are borne by the institution".

Our assessment

- Tranching is the essence of the concept of securitisation under the SR. Under article 2(6) of the SR, it is a "*contractually established segment of the credit risk associated with an exposure or a pool of exposures, where a position in the segment entails a risk of credit loss greater than or less than a position of the same amount in another segment*". This definition is broad. It naturally includes subordination made through issuance of senior notes and junior notes, but it is not exclusive to that. On the basis of this definition, the provision of a guarantee (or a deposit) purporting to indemnify holders exposed to a pool of assets/receivables in respect of their first loss is actually tranching.
- The ESA Position echoes the EBA's stance in 2018. The ESA have confirmed that a securitisation transaction does not necessarily involve a transfer of receivables. As a result, a direct lending vehicle originating loans funded by the issuance of senior and junior securities would actually carry out a securitisation transaction[2].
- Although their stance is logical, in this case the ESAs have taken a "form over substance" approach[3] to assessing whether a transaction is a securitisation. It may result in an approach that is too mechanical. This may lead to many structures unintentionally, and even unknowingly, falling into the category of securitisations[4]. Ironically, if a broader range of transactions are now considered securitisations, this could result in the ESAs having to adopt a more flexible/"substance over form" approach when assessing possible schemes of retention[5].
- At this stage, the best mitigant to avoid unwanted securitisation is to clearly show that, for any transaction which does not possess all the characteristics of a specialised lending exposure[6], the payments in the transaction or scheme are not dependent upon the performance of the pool of exposures (so that the originator – or in the example above the supplier – is still important in the credit risk analysis). This may not always be easy with financing usually structured with a SPV.
- Moreover, one may wonder whether, as a result of the "form over substance approach" taken by the three ESAs, credit insurance could also be considered as tranching.
  - The definition of tranching under the SR excludes "*credit protection provided by third parties directly to the holders of positions in the segment or in other segments*". The purpose of this carve-out is to exclude liquidity facilities and hedging arrangements since they do not modify the cash flows distributed to the securitisation vehicle. However, it would be in some measure artificial to consider that asset-level credit insurance falls within the ambit of this carve-out as credit insurance covers underlying exposures (receivables), not investors themselves.
  - That being said, synthetic securitisations are usually structured to distinguish themselves from contracts of insurance with the following characteristic: the payment obligations under a synthetic securitisation are not conditional on the protection buyer sustaining a loss or bearing a risk of loss. In other terms, the payment obligations under a synthetic securitisation are to be made regardless of whether the protection buyer has actually suffered loss or been exposed to risk of loss. However, this more a theoretical than a reliable approach based on clear legal provisions.
- The European legislator has recently made adjustments to the SR[7] to articulate the requirements of the SR and NPL transactions (in particular for the purpose of allowing servicers to be eligible retainers under the SR). This was beneficial for market participants to help avoid uncertainties by relying too heavily on "substance over form" or "look through" approaches. Ideally, similar adjustments could be considered to add a level of pragmatism with regards to questions on other financings qualifying as securitisations.

2 Answer to Question ID 2018_3806 : "The definition of "securitisation" according to Article 4(1)(61) of Regulation (EU) No 575/2013, as well as the definition of "securitisation" according to Article 2(1) of Regulation (EU) 2017/2402 (Securitisation Regulation), does not distinguish according to how or by whom a securitised position was generated. In particular, in order to classify a transaction or scheme as a securitisation, the CRR does not require an exposure to be first created or purchased by one party and transferred to another party afterwards. https://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2018_3806

3 by contrast to "substance over form approach" in respect of risk retention for eg

4 Besides, article 3(2) of EBA published final draft regulatory technical standards relating to risk retention pursuant to Article 6 of the SR provides that where the retainer is not a credit institution or an insurance undertaking retains an economic interest through a synthetic or contingent form of retention (ie through the use of guarantees), such retained interest shall be fully collateralised in cash, which may make transactions uneconomic.

5 See for e.g. our article on NPE available here: https://www.lexology.com/library/detail.aspx?g=b27ded0e-290c-4da8-95bc-1c12bf2900ed

6 The characteristics of a specialised lending exposure are listed in article 147(8) of the CRR.

7 Regulation (EU) 2021/557 of the European Parliament and of the Council of 31 March 2021 amending Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation to help the recovery from the COVID-19 crisis.

Key contacts

Joy Amis
Partner
London
T +44 20 7466 2840
joy.amis@hsf.com

Vincent Danton
Of Counsel
Paris
T +33 1 53 57 74 14
vincent.danton@hsf.com

Beatriz del Rey
Of Counsel
London and Madrid
T +44 20 7466 2912
beatriz.delrey@hsf.com

Philippe Desvignes
Senior Associate, Paris
T +33 1 53 57 69 82
philippe.desvignes@hsf.com

Leopoldo Gonzalez Echenique
Partner
Madrid
T +34 91 423 4117
leopoldo.gonzalezechenique@
hsf.com

Vincent Hatton
Partner
Paris
T +33 1 53 57 70 85
vincent.hatton@hsf.com

Jake Jackaman
Partner
London
T +44 20 7466 2883
jake.jackaman@hsf.com

Kai Liebrich
Partner
Frankfurt
T +49 69 2222 82541
kai.liebrich@hsf.com

Michael Poulton
Partner
London
T +44 20 7466 2777
michael.poulton@hsf.com

For a full list of our global offices visit **HERBERTSMITHFREEHILLS.COM**