



# Third Party Certification Agents



**PCS**

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## Introduction

In December 2017, the new STS Regulation became European law. The regulation introduced a new category of securitisations: “simple, transparent and standardised securitisations” or “STS securitisations” for short. The new STS regime will come into force on January 1, 2019.

STS securitisations are securitisations that meet set of long and detailed criteria and which the originator has certified and notified to the European Securities and Markets Authority (“ESMA”).

In addition, the STS Regulation also created an entirely new type of regulated entity: “third party certification agents” (“3PCAs”). The role of 3PCAs is to verify the originator’s own certification of the STS status of securitisations.

This booklet sets out a high level analysis of who third party certification agents will be, how will they be regulated and what their role is likely to be in the STS world.

## What do third party certification agents do?

Third party certification agents are an entirely new form of entity. They currently do not exist, nor can they exist until the STS securitisation regime comes into force. Their sole role and their defining activity is to verify the originator’s certification of a securitisation’s STS status.

In order for a securitisation to be an “STS securitisation” and benefit from the regulatory advantages available to these instruments, it is necessary that three conditions are met:

- the securitisation must meet all the statutory criteria for STS;
- the originator (or sponsor or SSPE) must publicly certify the STS status of the securitisation; and
- that certification must be notified to and published by ESMA.

The certification by the originator (or sponsor or SSPE) must set out how each of the STS criteria is met.

The regulation also allows an originator (or sponsor or SSPE) to hire a new type of market actor to publicly verify their certification. These must, however, be authorised by the appropriate regulatory authorities.

The use of a 3PCA to verify the originator’s STS certification is optional. It is not a requirement of achieving STS status for a transaction.

3PCAs can only be hired by the entity certifying the securitisation.

# How do third party certification agents support the market?

## *Issuers*

The STS Regulation provides very severe potential sanctions against both originators and their staff in cases where a securitisation has been notified as meeting the STS criteria and a regulatory authority has subsequently decided that this was an incorrect assessment. These can reach up to ten per cent. of an originator's worldwide turnover and Euro 5 million individual fines.

To become liable to these sanctions, the originator must either have knowingly and deliberately issued a false notification (ie fraud) or have been negligent.

The regulation prohibits an originator from transferring that liability to any third party, including a 3PCA. However, the originator's untransferable obligation is not to be negligent in certifying a transaction's STS nature. *The most effective way to ensure that one is not negligent is to hire an independent and competent STS expert to verify one's work.*

3PCAs will be experts in the STS regime. Their independence and competence will be the subject of a specific regulatory regime and overseen by national regulators.

The use of a 3PCA is likely to be the key to originators becoming comfortable that they may certify the STS nature of their securitisations without an unacceptable risk of later regulatory re-characterisation of the transaction with the attendant severe potential sanctions.

## *Investors*

The STS Regulation imposes on investors in STS securitisations the obligation to verify the STS status of their holdings. The investor community has indicated very vocally throughout the process of devising the new STS regime that the burden of a full STS compliance due diligence would be too heavy and lead to their deserting the STS market. Market participants as a whole also pointed out the gross inefficiency of requiring what is effectively the same compliance verification to be done multiple times for each issuance.

Policy makers were concerned, however, that investors should not mechanically rely on originators in determining a securitisation's nature.

The STS Regulation therefore allows investors to place some reliance on the originator's certification so long as it is not "mechanical". The investors cannot therefore merely check the ESMA website for an originator notification – that would be a mechanical reliance. Investors also do not have to do their own full due diligence of the STS criteria – that would be to place *no* reliance on the certification.

This leaves each investor having to determine what additional steps need be taken to make the reliance on the originator's notification more than merely mechanical.

The most logical answer is that an investor should insist on seeing a 3PCA's report – ie the verification of the originator's own certification and should perform due diligence on the 3PCA's competence and systems.

This also provides of the socialisation of the STS compliance due diligence costs to achieve an efficient market solution.

### **Regulators**

The STS market is subject to a dual fragmentation: a number of diverse originators and a number of diverse national regulators. This dual fragmentation raises the real possibility that STS criteria interpretation may diverge, leading to problems later on when these divergences become obvious. The existence of 3PCAs acting for various originators in different jurisdictions can provide a valuable regulatory early warning system. When divergent approaches or difficult interpretation issues emerge, a 3PCA with good regulatory contacts may alert regulators to the problem before it becomes unmanageable.

## **How are third party certification agents regulated?**

3PCAs are regulated at the national level by national competent authorities. Although which national authority will regulate 3PCAs in each country is still to be decided in the national capitals, it is anticipated that the role will fall to the local capital markets' regulator.

Once regulated in one European Union country, a 3PCA will be authorised to verify STS certifications across the whole EU.

3PCAs may not be banks or rating agencies.

3PCAs may not provide audit, advisor or equivalent services to the originator, sponsor or SSPE in securitisations they certify.

3PCAs may not engage in activities that compromise their independence.

3PCAs must charge cost-based, non-discriminatory fees.

3PCAs must have at least two independent directors.

## 3PCAs and Brexit

The STS Regulation became law in the United Kingdom in December 2017. As such, it is extremely likely that it will remain part of UK law following Brexit in accordance with the provisions of the Withdrawal Act.

As a result, the full STS regime, including its third party certification agent provisions, will remain part of the British capital markets following any exit from the European Union.

## PCS and 3PCA's status

PCS has publicly indicated that it intends to apply to be authorised as a third party certification agent both in the European Union and (post-Brexit) the United Kingdom. PCS believes that by becoming a not-for-profit 3PCA market utility it will fulfill its original mission to support the revitalisation of the European securitisation market.

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