Roller-coaster ride for the securitisation market

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Banking & Finance analysis: Robert Cannon, a special counsel in the capital markets team at Cadwalader, Wickersham & Taft LLP, considers the EU securitisation regulation adopted by the European Parliament on 26 October 2017 and the impact it will have on the European securitisation market.

Original news

European Parliament adopts new rules for EU securitisations, LNB News 27/10/2017 37

The European Parliament has approved new rules to create a European framework for simple, transparent and standardised (STS) securitisations, as well as new rules on preferential capital treatment for STS securitisations. The rules are aimed at reviving securitisations in the EU, which declined after the US sub-prime crisis in 2008.

What is the background to the European Parliament vote?

In September 2015, the European Commission proposed a regulation to lay down common rules on securitisation and to create a European framework for STS securitisation (the Regulation). In December 2015, the Council of Ministers, made up of representatives of the 28 EU Member States, adopted an agreed text on the Regulation with some relatively minor amendments to that proposed by the Commission. After lengthy deliberations throughout 2016, the European Parliament proposed significant amendments to the text proposed by the Commission.

During the first half of 2017 there were a series of trilogue meetings among representatives of the European Commission, the Council of Ministers and the European Parliament to reach an agreed position on the Regulation. In June 2017, these representatives reached political agreement on a text of the Regulation which was published. Following some minor revisions to tidy up the politically-agreed text and to address some concerns in relation to the rules on credit-granting, a revised text was published and adopted by the European Parliament.

When will the Regulation apply and what are the next steps?

The Regulation provides that it is to apply from 1 January 2019. The next step is for the Council of Ministers to adopt the same version of the Regulation as adopted by the European Parliament. The Regulation will then be translated into all of the working languages of the EU and published in the Official Journal of the European Union. The Regulation will come into force 20 days after such publication, which is expected to occur during the first calendar quarter of 2018.

The Regulation provides, in relation to certain of its provisions, for the adoption of more detailed rules in the form of regulatory technical standards by the European Commission. Some of those regulatory technical standards are to be adopted within six months of the Regulation coming into force whereas others are to be adopted within one year. The relevant EU financial regulator specified in the provision of the Regulation, eg the European Banking Authority, proposes to the European Commission a text for such regulatory technical standards. Such proposal usually follows a public consultation and, sometimes, a public hearing, to obtain input from interested parties. It is expected that those regulatory technical standards under the Regulation will be a focus of attention for the securitisation market during 2018.

What will be the effect of the Regulation introducing the concept of STS securitisation?

Investments in STS securitisations will benefit from lower risk capital weightings for EU banks and insurers compared with investments in other securitisations. Those securitisations which can satisfy the criteria to be STS securitisations—principally mortgage-backed securities and certain types of asset-backed securities—will become more attractive as investments, perhaps benefiting from better pricing and liquidity as a result. However, there are many types of securitisations, such as commercial mortgage backed securities (CMBS) and leveraged loan CLOs, where it does not appear to be possible to satisfy the criteria for STS securitisations and so the overall impact on the European securitisation market may be limited.

How will the Regulation impact risk retention for securitisations?

Currently, EU securitisation rules restrict certain types of regulated investors, such as banks, investment firms, insurers and alternative investment managers, from investing in securitisations where an originator, sponsor or original lender does not hold a 5% risk retention in the securitisation or the underlying assets. However, there is no requirement on those securitising assets to have such a 5% risk retention and there have been a number of European securitisations where none of the investors have been regulated entities and which have not provided for any 5% risk retention. The Regulation will change the rules so that originators, sponsors and issuers of securitisations are responsible for ensuring that there is a 5% risk retention.

There is no jurisdictional scope set out in the Regulation and so it is unclear how far its scope extends. However, it is considered that a securitisation where none of the originator, sponsor and issuer is an EU entity and where none of the assets are EU-based would not be subject to the 5% risk retention requirement under the Regulation. The market is hoping that the jurisdictional scope will be clarified in the regulatory technical standards adopted by the European Commission.

The Regulation will also impose a new limit on the entities which can satisfy the EU rules by holding the 5% risk retention. As is the case under the current EU rules, the Regulation provides that the rules will be satisfied if the retention is held by an originator, sponsor or original lender. However, the Regulation provides that an entity shall not be considered to be an originator where it has been established or operates for the sole purpose of securitising exposures.

Why does the Regulation impose a ban on resecuritisations?

A resecuritisation is a securitisation at least one of the underlying exposures of which is itself a securitisation position. The Commission proposal did not include a ban on resecuritisations. Regulatory capital rules for EU banks and insurers already impose very high risk capital weightings on investments in resecuritisations and essentially rule out investment by such entities in resecuritisations. Since the financial crisis the number of resecuritisation transactions has in any case been negligible.

The European Parliament proposed the ban on resecuritisations on the basis of the contribution that resecuritisations such as structured investment vehicles (SIVs) and collateralised debt obligations (CDO) squareds made to the financial crisis. In order to have a full understanding of an investment in a resecuritisation it is necessary to analyse and model not only the resecuritisation itself but also the securitisations to which the securitisation positions held by the resecuritisation relate, which is difficult to do.

However, the Regulation contains a couple of exceptions from the ban on resecuritisations. First, asset-backed commercial paper programmes are not to be considered resecuritisations provided that credit enhancement at the programme level does not establish a second layer of tranching. Secondly, competent authorities may permit individual resecuritisations for certain purposes specified in the Regulation, including the establishment of a ‘bad bank’ structure to facilitate the continued operation or winding up of a bank or financial institution.

Why were the criteria for credit-granting controversial in the proposed text, and how is this addressed in the Regulation?

The Regulation applies to all originators, sponsors and original lenders the existing requirement that applies only to EU banks to apply the same sound and well-defined criteria for credit-granting to exposures which they securitise as they apply to exposures which they retain. The Regulation also extends the scope of the requirement to require that credit-granting is ‘based on a thorough assessment of the obligor’s creditworthiness taking appropriate account of factors relevant to verifying the prospect of the obligor meeting his obligations under the credit agreement’.

The securitisation market’s issue with the credit-granting requirements under the Regulation is that they require an entity securitising assets acquired from a third party to verify that such third party applied the same sound and well-defined criteria for credit-granting to such assets as such third party applies to exposures which it retains. This is something that is virtually impossible to verify after the assets have already been acquired. Up to now there has been no reason to cover this point in due diligence or seller representations in transactions involving the sale of portfolios of loans or other assets. The Regulation provides that, in the case of assets which are originated prior to 20 March 2014, the entity securitising the assets may, instead of the required verification, apply to the assets the same sound and well-defined criteria for credit-granting to exposures which it securitises as such entity applies to assets which it retains. However, this exception is of limited utility because it does not apply to assets originated on or after 20 March 2014 and it is difficult to see how it is to be applied where the entity securitising the assets does not itself originate or retain assets.

How does the Regulation affect the securitisation of self-certified mortgages?

The Regulation includes a restriction on the inclusion in securitisations self-certified mortgage loans. In the June 2017 politically-agreed text of the Regulation this would have restricted any securitisation effected after the coming into force of the Regulation from including self-certified mortgage loans, negatively effecting legacy self-certified mortgage loan portfolios. However, in the Regulation approved by the European Parliament the restriction only applies in respect of self-certified mortgage loans originated on or after 20 March 2014. This date was chosen because it was the date of entry into force of the EU Mortgage Credit Directive 2014/17/EU, which included an effective prohibition on self-certified mortgage loans. However, the Mortgage Credit Directive did not have to be implemented in EU Member States until 20 March 2016 so there will be some legacy self-certified mortgage loans originated between 20 March 2014 and 20 March 2016 which will become unsecuritisable following the entry into force of the Regulation.

How has the market received the Regulation?

The two-year progress of the Regulation through the EU legislative process has been a roller-coaster ride for the securitisation market. The principal purpose of the original Commission proposal of September 2015 was to create a category of STS securitisation and lower risk capital weightings that would apply to EU banks and insurers investing in such securitisations. The market was disappointed that the criteria for STS securitisations were relatively restrictive and was also less than happy that some of the changes proposed by the Commission to the existing risk retention rules would make them slightly more restrictive.

In June 2016, the European Parliament rapporteur published a draft report with amendments to the text of the Regulation contained in the Commission's proposal. Some of those amendments would have been extremely negative for the securitisation market, including an increase in the risk retention level from 5% to 20%, a requirement that only regulated entities could securitise assets or invest in securitisations, a requirement that investors notify the regulator of any acquisitions of securitisations and that securitisations report on their investors. Not all of the amendments were ultimately accepted by the European Parliament but some that were, such as a requirement for a 10%, rather than the current 5%, retention where in the form of a first loss piece, were considered very problematic.

For the past year the market has been pushing back against proposals of the European Parliament and was generally relieved when the politically-agreed text published in June 2017 dropped or significantly watered down the proposals from the European Parliament which would have most impacted on the market and maintained the required size of the retention at 5% for all forms of retention. At that point it was not clear that the market is pleased that the date for application of the Regulation will now be 1 January 2019 rather than earlier. This timing gives the market the time to complete securitisations under the existing rules and gives visibility on the new rules at an early stage when structuring during 2018 securitisations, which might only close in 2019. In the case of some of the regulatory technical standards to be adopted under the Regulation, this timing means that they will be consulted on and adopted by the Commission in advance of the Regulation applying so that more details of the new regime are known before it starts to apply in practice.

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