KEY POINTS

- A new framework governing EU securitisations is applicable to securitisations the securities of which are issued on or after 1 January 2019.
- The framework sets out criteria for simple, transparent and standardised (STS) securitisations which may benefit from regulatory capital relief.
- While preferential treatment for STS securitisations is helpful, there are a number of outstanding issues which may result in slow uptake for STS securitisations in the coming year.

Feature

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STS: a new age for European securitisations

In this article, Nick Shiren and Alex Collins consider how STS (simple, transparent and standardised) status is achieved under the Securitisation Regulation.

Following the financial crisis of 2007-2008, regulators across the globe turned their attention to the securitisation markets. Restrictive regulatory regimes were introduced, and securitisation issuance, already harmed by the crisis, was greatly diminished.

However, by 2015, the European Parliamentary Research Service was ready to admit that securitisations "… may even have broader economic and social benefits".

The European Commission (EC) put in place plans to revitalise the securitisation market and, following a lengthy legislative process, on 28 December 2017 the "Securitisation Regulation" (Regulation (EU) 2017/2402) was published, along with, and on the same date, the "CRR Amending Regulation" (Regulation (EU) 2017/2401). With the Securitisation Regulation, the EC came full circle and expressed its support for securitisations again, calling them an "important element of well-functioning financial markets".

Together, these regulations seek to harmonise EU laws applying to securitisations and put in place a new framework for simple, transparent and standardised (STS) securitisations, which would provide certain credit institutions and investment firms (CRR Investors) and (pursuant to a separately applicable regulation) insurance and reinsurance undertakings (together with CRR Investors, "STS Investors") with preferential regulatory capital treatment (ie a lesser amount of cash or high quality assets to be held against the securitisation position).

The creation of STS securitisations represents a new age for EU Securitisations. However, there are a number of hurdles and unresolved issues remaining at the time of writing (mid-January 2019) that will need to be resolved before STS securitisations can be issued, and ultimately reach their full potential. Without resolving these, the proper implementation of the framework and the adoption of STS securitisations by the market is at risk.

SCOPE OF ARTICLE

While the Securitisation Regulation sets out requirements for all securitisations, it also sets out additional criteria for those securitisations seeking to rely on the STS label, thereby bifurcating the securitisation market from a regulatory standpoint and creating a new, arguably higher standard of securitisation product.

To qualify as an STS securitisation, the rules which are applicable to all securitisations under the Securitisation Regulation (such as risk retention, due diligence requirements and transparency requirements) will need to be complied with. A number of issues with these requirements (in particular regarding transparency) remain unresolved at the time of writing. The detail of those provisions is not the subject of this article and focus is instead on how STS status is achieved.

The Securitisation Regulation also provides for different treatment for short-term securitisations (asset backed commercial paper or "ABCP") as compared to longer term securitisations. While ABCP transactions can also benefit from the STS label, this article focuses on the criteria and rules applicable to non-ABCP STS securitisations.

STS: HOW TO JOIN THE CLUB

For a securitisation to qualify as an STS securitisation, it will have to:

- satisfy the general requirements of the Securitisation Regulation (as discussed above);
- satisfy the additional STS criteria (STS Criteria);
- be designated (and notified to the European Securities and Markets Authority (ESMA)) as STS by the originator and the sponsor; and
- appear on a list of STS securitisations maintained on ESMA's official website.

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Obtaining the STS label is not in itself sufficient for STS Investors to benefit from the regulatory capital relief that STS promises to deliver. Hidden away in the CRR Amending Regulation are further requirements (CRR Criteria).

While aspects of the framework are subject to further detail and guidance, set out below are the requirements as they currently stand.

STS CRITERIA

The STS Criteria are (predictably) split into

three categories: simplicity, standardisation and transparency. At the time of writing the EBA has released non-binding guidelines (STS Guidelines) which will apply from 15 May 2019 to assist national competent authorities and market participants with interpretation of the STS Criteria. The STS Criteria are extensive. Certain key requirements are broadly as follows:

Simplicity (Art 20 Securitisation Regulation)

- Underlying exposures must be transferred by means of true sale, assignment, or transfer with the same legal effect – no severe clawback provisions are allowed where the seller of underlying exposures becomes insolvent. The STS Guidelines require a legal opinion to be provided on this, a requirement which arguably goes beyond the Securitisation Regulation text.
- Where assignment of the underlying exposures is to be perfected, specified perfection triggers must be in place, focusing on credit quality deterioration, insolvency of the seller and unremedied breaches by the seller.
- Representations are required from the seller that the underlying exposures are not in a condition that would affect enforceability of the true sale analysis.
- Active portfolio management of assets is not permitted subject to the STS Guidelines carve outs for substitution for breaches on underlying exposures, replenishment, repurchase for clean-ups or defaulted assets and ramp up.
- Asset types in the pool must be homogenous. This is the subject of separate draft regulatory technical standards (Homogeneity RTS) and is discussed below.
- The underlying exposures must be full recourse to debtors and have defined periodic payment streams.
- Origination of assets must have been in the ordinary course of business, with underwriting standards no less stringent than those applied to that originator's non-securitised assets. Changes in underwriting standards after the closing of the securitisation must be disclosed. The STS Guidelines clarify that the originator is not required to hold the similar non-securitised assets or to have originated them at the same time as the securitised exposures.
- Defaulting assets and credit-impaired debtors cannot form part of the pool unless there is a guarantor (that is not also credit impaired) for the full securitised exposure amount (as clarified by the STS Guidelines). At least one payment must have been made on the asset by the debtor.
- The structure of the securitisation cannot depend predominantly on the sale of assets securing the underlying exposures.

Standardisation (Art 21 Securitisation Regulation)

- Interest rate and currency risk must be appropriately mitigated and there must be no derivatives in the underlying pool. The STS Guidelines specify that "a major share" of the interest rate and currency risks must be hedged.
- On enforcement there can be no cash trapping (other than where favourable to investors), amortisation must occur sequentially and there can be no automatic sale of assets at market value.
- Where the priorities of payments allow for non-sequential payments, there must be triggers at specified pre-determined levels linked to the performance of the underlying exposures on which payments revert to sequential payments.
- Early amortisation or termination of revolving periods must occur where credit quality or the value of underlying exposures falls below a predetermined threshold, on the insolvency of the servicer, or, where the securitisation is revolving, it is not possible to generate sufficient new underlying exposures.
- The servicer must have expertise in servicing exposures of a similar nature, with policies, procedures and risk management controls in place that relate to servicing such exposures. The STS Guidelines require the documented policies, procedures and risk management controls of unregulated servicers to be substantiated by a third-party (such as a credit rating agency or external auditor) review, but the lack of clarity in this area may in practice restrict STS servicers to regulated entities.
- Conflict resolution between classes of investors and voting rights must be clear and facilitate timely resolution of conflicts between classes. The STS Guidelines require provisions specifying a maximum time during which a meeting to resolve a conflict must take place.

Transparency (Art 22 Securitisation Regulation)

- The originator and sponsor must provide historical default and loss performance data covering a period of at least five years in respect of substantially similar exposures to those being securitised before pricing. The STS Guidelines allow for the use of publicly available or third-party data if the seller is unable to provide data.
- A sample of the underlying exposures and data is to be subject to external verification by an independent party.
- The originator or sponsor must provide a liability cash flow model before pricing and ongoing after pricing.

STS NOTIFICATION

In the case of a securitisation meeting the STS Criteria, originators and sponsors will need to notify ESMA using a specific form (STS Notification) and it must then appear on the list of STS securitisations on ESMA's official website.

The STS Notification is more than a simple confirmation and requires an explanation of how each of the STS Criteria has been complied with.

At the time of writing, draft regulatory technical standards have been produced by ESMA (Notification RTS) specifying the information required to be included in the STS Notification in the form of template annexures.

The STS Notification contains a line item for each STS Criterion which requires either

confirmation, a concise explanation, or a detailed explanation, as applicable.

In respect of public securitisations (ie securitisations for which a Prospectus Directive compliant prospectus must be drawn up) the STS Notification will be published on ESMA's website once the Notification RTS apply.

Originators and sponsors of private securitisations (ie without a Prospectus Directive compliant prospectus) are still required to complete and submit a full STS Notification. However, this will not be published and instead a second anonymised notification must also be submitted, which will be published.

If an STS securitisation no longer satisfies the STS Criteria the originator and sponsor must immediately notify ESMA, who will update the list accordingly.

CRR CRITERIA

Obtaining the STS label does not automatically qualify the STS securitisation for preferential regulatory capital treatment for STS Investors. The CRR Criteria below will need to be satisfied before advantage can be taken of any lower risk weighting.

- The aggregate value of all underlying exposures to a single obligor cannot exceed 2% of the aggregate value of all underlying exposures.
- Risk weighting of the underlying exposures must not be greater than the following percentages as a total of the pool:
  - 40% (weighted average basis) for loans secured by residential mortgages or fully guaranteed residential loans;
  - 50% (individual exposure basis) for loans secured by commercial mortgages;
  - 75% (individual exposure basis) for retail exposures; or
  - 100% (individual exposure basis) for all others.
- Where the exposures are loans secured by residential and commercial mortgages, loans secured by lower ranking security for an asset can only be included in the pool if all loans secured by prior ranking security are also in the pool.
- Where the exposures are loans secured by residential mortgages or fully guaranteed residential loans, the pool must have a loan to value ratio higher than 100% at the time of inclusion in the securitisation.

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HOMOGENOUS ASSET TYPES

One of the biggest question marks surrounding the implementation and ability to designate securitisations as STS is the requirement that the underlying exposures in the securitisation are homogenous.

This requirement has been fleshed out in the Homogeneity RTS which, at the time of writing, are in draft form and are being considered by the EC.

The requirement consists of four conditions:

- similar underwriting standards;
- similar servicing procedures;
- same asset category; and
- (other than in respect of trade receivables and personal credit facilities), homogenous with reference to at least one "homogeneity factor".

Asset categories include residential and commercial mortgages, personal and corporate credit facilities, auto loans and leases, and credit card and trade receivables.

Homogeneity factors include type of obligor, security ranking of rights on property, type of immovable property, and jurisdiction of property/obligor, although they are not all available for each asset category. Determination of the homogeneity factor should be the result of "flexible analysis" on a "case-by-case determination" by the originator or sponsor.

There is some concern among market participants that the rigid nature of the homogeneity requirements could frustrate STS issuance. In particular, the lack of any materiality thresholds allowing for a small percentage of assets which may be exceptions to the requirements could mean that originators and sponsors are less likely to issue STS for fear of inadvertently falling foul of these requirements. It now seems unlikely that a materiality threshold will be introduced, and it remains to be seen what impact this will have on STS issuance.

WHO IS INVITED?

Grandfathering

The Securitisation Regulation applies to securitisations issued on or after 1 January 2019. Transitional provisions however allow for securitisations issued prior to 1 January 2019 (Historic Securitisations) to be considered STS if they met, at the time of issuance, a number of the STS Criteria (including the risk retention requirements) and if they meet, at the time of STS Notification, certain other of the STS Criteria, including those in respect of underwriting standards and seller representations. In the case of the latter, this may cause issues where representations from sellers are effective for a limited period of time.

The Notification RTS also caters for Historic Securitisations – line items can be "not applicable due to the application of transitional provisions".

Excluded securitisations

The Securitisation Regulation (either explicitly or through the STS Criteria) excludes certain products from being STS:

- commercial mortgage backed securities – the stated rationale including the fact that cash flows rely on the sale of assets securing the underlying exposures and the poor performance of this asset class during the financial crisis;
- resecuritisations, being one of the main

Feature

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culprits of the financial crisis;
- securitisations with active portfolio management, thereby excluding collateralised loan obligations;
- synthetic securitisations, although "balance-sheet synthetic securitisations" may in the future be brought into the STS framework.

Jurisdiction

STS is strictly a European affair – originators, sponsors and securitisation special purpose vehicles (SSPEs) involved in STS must be established in the European Union.

RESPONSIBILITIES

The STS regime is one of self-certification. Originators and sponsors are jointly responsible for the securitisation complying with a number of the STS Criteria, and for the STS Notification requirements.

There are a number of instances where third parties can be engaged in order to assist with aspects of STS – in particular as regards the verification of STS compliance, the details of which are subject to separate regulatory technical standards (which are also currently in draft form). Such third-party verification entities will need to register with ESMA and are required to comply with a number of non-conflict and suitability criteria.

The use of third party verification and the STS Notification itself does not absolve investors of the need to comply with their due diligence requirements and investors cannot rely "mechanistically" on the STS Notification or third-party verification. In addition, the liability of originators, sponsors and SSPEs will not be affected by the use of such third parties.

THE CARROT

The CRR Amending Regulation brings into play a hierarchy of risk weighting methods to be used by CRR Investors, however each of them is modified for the purposes of senior positions in STS securitisations such that the risk weight floor is 5% lower than the 15% floor for non-STS securitisations.

The hierarchy of methods can also be subverted if the application of a particular method results in the risk weight being higher than 25%.

There are also amendments to regulations affecting the capital treatment of STS securitisations in respect of certain insurance and reinsurance undertakings, replacing the previously preferred "types" of securitisations with senior and non-senior STS securitisations.

While preferential capital treatment is helpful, there remains an issue around the treatment of STS for liquidity coverage ratio purposes (ie assets required to be held by financial institutions that qualify as highly liquid for the purposes of satisfying short term obligations).

While it was initially expected that senior STS positions would be included in the second highest quality tier and therefore, be subject to a lower haircut, this was not included in the liquidity coverage ratio draft delegated regulation, and it is not clear whether any changes will be made to cater for this.

THE STICK

The Securitisation Regulation sets out a range of fines and sanctions for breaches relating to STS securitisations including where the originator, sponsor or SSPE has negligently or intentionally:
- failed to meet the STS Criteria;
- incorrectly designated a securitisation as STS; or
- failed to notify ESMA and the relevant competent authority that a securitisation no longer satisfies the STS Criteria.

Competent authorities now have the power to implement sanctions and measures including:
- a public statement identifying the nature of the infringement;
- a temporary ban on members of the management body from exercising similar management functions;
- a temporary ban preventing future STS Notifications; and/or
- a fine – the maximum of which is €5,000,000 or up to 10% of total annual net turnover – or in some cases, at least twice the amount of benefit derived from the infringement, even if that exceeds the previously stated fines.

Competent authorities will have to take into account certain factors when considering measures to impose including materiality, duration, financial strength of entity and profit and loss resulting from the breach.

Where there has been non-compliance with the designation of a securitisation as STS "in good faith", competent authorities can grant up to three months to remedy the infringement.

CONCLUSION

The path to redemption for securitisations is long and painful. There are numerous outstanding issues and draft regulatory measures that need resolution before market participants can comfortably take advantage of them. That, coupled with the severity of the sanctions, may mean a slow uptake for STS securitisations in the coming year.

However, a new age is on the horizon and market participants have reason to be hopeful. While the current status of the regulations is uncertain, the momentum represents a positive step towards reintegrating securitisations into the economy in a non-punitive manner. ■

Further Reading:
- Long-awaited securitisation framework comes into force (2018) 2 JIBFL 114.
- The STS Securitisation Regulation: a revival or the status quo for European CLOs? (2016) 2 JIBFL 95.
- LexisPSL Banking and Finance blog: Roller-coaster ride for the securitisation market.