STS easy as STC, easy as 1, 2, 3. Or is it?
Operational efforts to revive the securitisation market
Executive summary

Certification, Ambiguity and Operational readiness are the key challenges of the published criteria for STS securitisation.

On 30 September 2015 the European Commission (EC) published its initial draft Regulation for common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation. A revised compromise draft was published in December 2016. If passed this legislation would supersede all other European regulations and directives concerning securitisation. This single regulation would bring an end to the current piecemeal approach to regulating securitisation transactions and markets in the European Union. The momentum behind this regulatory initiative to revive the securitisation market could see the regulation being implemented in H2 2017. This would be ahead of Basel requirements to implement the revised capital framework for securitisation by January 2018.

It is our view that implementation of the STS criteria in the context of a single regulation for securitisation could have a significant positive effect on reviving the market, through addressing longstanding concerns about regulatory uncertainty. In their efforts to rejuvenate securitisation markets, European and Global regulators need to be mindful of balancing desires to encourage a market only for more standardised transactions against the innovation necessary to fund certain real economy assets such as SME lending.

This paper reviews Articles 8, 9 & 10 of the recent draft Securitisation Regulation published by the European Commission, and identifies some of the challenges posed by the regulation of simple, transparent and standardised securitisations. These include:

- **Certification:** The potential evolution of self-attestation requirements into calls for 3rd-party certification.
- **Ambiguity:** Where aspects of the criteria are open to interpretation, we consider what (if any) steps stakeholders could take prior to any regulatory efforts to provide clearer guidance.
- **Operational readiness:** Many parts of the criteria are clear and require operational improvements to be made by issuers and investors. Market participants may wish to take steps to begin making these improvements in advance of all ambiguities in the criteria being addressed.

As part of our review each of the 24 criterion are classified as either high, medium or low impact reflecting the extent to which current business-as-usual practices may need to be adjusted or could be affected by the implementation of each criteria.

Nine of the criteria are identified as having a high impact and a further nine as having a medium impact to the existing practices of issuers and investors, should they wish to participate in the STS securitisation market. We anticipate changes arising from these criteria will cover aspects such as, adjustments to the typical structures and structural features used in securitisation transactions, the scope of potentially increased liability for issuers, and how changes in origination and underwriting procedures are communicated to and appraised by potential investors.

Focussing on the criteria classified as potentially having a high or medium impact, the discussion outlines challenges posed and what market participants may wish to consider when approaching simple, transparent and standardised securitisations. The paper goes on to identify the next steps in the regulatory agenda and suggests what next steps market participants could take.

As well as discussing the key points of the draft Securitisation Regulation in order of impact for market participants, this paper provides some background on the movement of international regulatory bodies with regards to securitisation post-crisis.

9 of the 24 criteria are identified as having a high impact on BAU practices of securitisation originators.
Introduction

During the 2007 financial crisis, securitisations underpinned by “sub-prime” US mortgages gained a tarnished status within the eyes of many. Rightly or wrongly this spread beyond its origins of securitisations backed by US sub-prime, and negatively affected opinions and attitudes towards all types of securitisations globally.

This resulted in securitisation transactions more generally falling out of favour with investors and a hardening regulatory stance around the world towards this market. This has manifested itself through the combination of the redrafted Basel III regulatory capital treatment and heightened regulatory supervision of exposure to securitisations transactions and issuance programmes.

Post crisis a new question arose at many central banks, how can lending to the “real” economy be increased? In this context securitisation was no longer viewed as part of the problem, but was in fact seen as part of the solution.

In 2010 the European Central Bank (ECB) began working on its Loan Level Data (LLD) initiative. One objective of this was to introduce transparency to what some considered an opaque market. LLD launched in January 2013, and while this alone was not a panacea for securitisation markets, it was a first step towards rehabilitation of the asset class, through giving investors the ability to see loan by loan data on the exposures underlying a securitisation.

Also at this time, work had begun among various industry groups examining what they could usefully do to restart the market themselves. This generated discussion around what might constitute “high quality” or “qualifying” securitisation which would help to rehabilitate the asset class in the eyes of investors.

In May 2014 the Bank of England (BoE) and ECB released a joint discussion paper around what might constitute such a qualifying securitisation. Arguably this paper signalled the first public move by central banks to consider differentiating between securitisation transactions that met certain qualifying criteria. In October 2014 the European Banking Authority (EBA) also published a discussion paper on what were then dubbed Simple, Standard and Transparent securitisations.

This was then followed by the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) jointly producing a paper in December 2014 on Simple, Transparent and Comparable (STC) securitisations. This paper touched many of the same topics as the ECB/BoE paper of six months earlier, but it also drew together some of the wider thinking that had gone on globally.

In 2015 the Junker commission identified the creation of a Capital Markets Union (CMU) as one of its major priorities during the next European Parliament. The flagship policy within CMU is the Securitisation Regulation, which seeks to define what Simple, Transparent and Standard (STS) securitisations look like and gives them differential capital treatment to regular securitisations.

Over the past ten years the regulatory stance on securitisation markets seems to have come full circle. Having been considered one of the root causes of the crisis in 2007, certain securitisations (specifically “good” ones such as STS might be considered) are now seen as just what the EU needs to get credit flowing and boost growth in the European economy.

1. ECB Loan Level Data Initiative
2. The case for a better functioning securitisation market in the European Union, May 2014
3. EBA Discussion paper on simple standard and transparent securitisations, October 2014
4. Criteria for identifying simple, transparent and comparable securitisations, December 2014
6. Proposal for a regulation laying down common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation, September 2015
**Simplicity**

The nine criteria under the initial “S” of Simplicity of STS, encourage focus on the simplicity of assets, structures and investors ability to enforce on either the assets or the securitisation vehicle. In large part these criteria are straightforwardly satisfied.

**Criterion 1**

Severe clawback provisions need to be considered in order to establish if any such clawback provisions exist, and critically what the acceptable level of severity is.

**Criterion 2**

Not encumbered or foreseen to adversely affect enforceability may be difficult to cover if commenting on assets which have not been through a sufficiently long performance period, for all enforceability issues to have been identified. Originators may find it difficult to comment on future enforceability, but have historically borne this risk.

**Criterion 4**

Homogeneity relates to the age-old consideration of the degrees of similarity of assets and how far this extends to securitisations of mixed pools of assets such as auto loans/ commercial loans/leasing etc. in the same transaction. On initial reading, the regulatory text appears to be clear that homogeneity with respect to asset type is a key consideration and therefore mixed pools are not expected to meet with STS requirements. With respect to pools of assets of the same type, regulatory expectations outline that the credit quality of assets within the pool should fall within a defined band (possibly a tight band) of credit risk metrics, in line with market conventions. It may be the case this is addressed by, amongst other things, a clear definition of portfolio eligibility criteria. However, in a recent effort to increase clarity by further defining “homogeneous”, the draft regulations introduce ambiguity by suggesting grouping certain types of assets which would typically be separated. There now appear to be four separate categories of asset type: specifically a) residential b) corporate and business c) autos and d) consumer credit. In light of this regulatory update, the definition of homogeneity has become broader, more diverse and arguably less transparent.

**Criterion 6**

This criterion tackles a number of regulatory considerations including the originate-to-distribute business model, the associated weakening of underwriting standards as well as ensuring the ability of investors to analyse the credit quality of underlying asset pools is not hindered by having pools of mixed credit qualities. Originators are encouraged to communicate clearly to investors any (material) changes to underwriting criteria, but there is no guidance as to what constitutes a material change. This aspect of ambiguity on materiality of changes in underwriting standards is the most significant ambiguity affecting not only securitised assets, but potentially also the ability to securitise new assets underwritten with a (materially) less stringent underwriting standard.

Through clear communication between originators and investors of changes in underwriting standards, market practices and conventions may evolve to enhance investor and market confidence with respect to their securitisation exposures. Requirements for originators to have expertise in originating exposures similar those securitised, should also address concerns of investor confidence. For established lenders this is of little consequence if they wish to securitise long-originated assets. However new lenders and existing lenders originating new asset types, should carefully consider if they intend to issue securitisation to fund or transfer the risk of such assets, and how they will aim to meet STS requirements. In considering how to satisfy the requirement to have sufficient experience originators may wish to consider how they reflect the industry experience of key individuals in management teams and how their experience/skills have been embedded in the operations and governance of the new lending activity.

Of lesser significance to originators, but still noteworthy are criteria 1, 2, 4, 7 and 9.

**Criterion 7**

Default/credit impaired at the time of the transfer, not the time of origination, may prove to be an issue for originators with seasoned portfolios, who are not monitoring the credit quality of borrowers on an on-going basis. The application of sub-criterion 7(c) raises interesting questions with respect to what the appropriate benchmark loan type should be for determining significantly higher default rates. As with many of the other criteria the detailed disclosure of how the criteria are met will be critical.

**Criterion 9**

That repayment shall not depend predominantly on the sale of an asset, requires consideration of asset types such as interest only mortgages or residual value auto loan/lease transactions where noteholders are exposed to the market value of the asset.

**Criterion 9a**

The latest draft states that arbitrage synthetic securitisations cannot be part of STS securitisations. In addition, the wording leaves open the prospect of balance sheet synthetic securitisations being permitted, where assets are either retained on the originator’s balance sheet or are transferred to a Securitisation Special Purpose Entity (SSPE) through a true sale.

**Criterion 9b**

Identifies ESMA taking the lead on developing the regulatory technical standards (RTS) which will underpin criterion 4 on homogeneity. The requirement for the RTS on homogeneity, results in continued uncertainty over how homogeneity will be established. These RTS will be submitted to the EC within 6 months of the regulation coming into force.
Transparency

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<th>Prioritisation of criteria considering impact and preparedness</th>
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<td>Medium</td>
<td>None</td>
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Targeting the availability for investors to source clear, better and more disclosure of metrics and features of the transaction as well as asset specific data and definitions, has the potential to create significant operational requirements. Non-compliance against the criteria outlined here has the potential to be a significant signal to securitisation market investors about the capability of the Originating entity to provide the outlined data and related on-going management of underlying assets to the securitisation.

**Criterion 1** requires the sharing of data on loss and default experience, on substantially similar assets. Originators are encouraged to establish their view on “substantially similar” and communicate this to investors, allowing for a debate (bilateral or market wide) on what they consider to be appropriate and comparable across the offerings of different originators. The operational requirements are likely to be substantial for originators to collate and provide the information and for investors to be able to review and interrogate the data.

**Criterion 3** dictates the provision by the Originator for investors, of a liability cash flow model at pricing and periodically throughout the life of the transaction. Originator institutions are now explicitly required to make available a clearly documented liability cash flow model to investors. Therein lies a suggestion that the provision of such details to investors must ensure clarity and transparency, most likely through the inclusion of qualitative as well as quantitative documentation. It may be possible to satisfy this requirement in multiple ways. Originators ought to consider issues related to legal and financial exposure they wish to bear on accuracy of published models and how they are able to gain comfort about the accurate reflection of the transaction in the model, for example through independent model reviews or hosting of liability models on market data systems.

**Criterion 3a** was introduced with the admirable intention of encouraging a securitisation market that functions in unison with other capital markets and consumer financing technologies, however, the resulting ambiguity is considerable. The Regulation requires the originator institution to publish information over the long-term, regarding the sustainable nature of the securitisation using environmental, social and governance criteria. Accurate comprehension and appropriate adherence to this requirement would pose difficulty for Originators given this will mean very different things to different stakeholders.

**Criterion 4** identifies elements of the Prospectus Directive and how they ought to be considered for STS securitisation. In particular the criteria refers to a broader part of the draft securitisation regulation related to Transaction documents and which of these are available at or before pricing. Naturally many of these documents contain price and market sensitive information relevant to the upcoming transaction that regulators consider should be available for investors as part of their investment decision process. Originators ought to consider how such documents will be made available to investors prior to pricing as well as how such access will be delivered and maintained for the transaction documents that are ultimately finalised at the Closing of a securitisation transaction. Given that the Prospectus Directive is not an EU Regulation, there are some differences in implementation of the directive across member states which Originators may need to consider. A review of the Prospectus Directive is identified in the Commissions CMU Action Plan, which may result in changes to legislation; however a timescale for the review is unclear.

Operational requirements are likely to be substantial for originators.
### Standardisation

The second “S” for Standardisation provides eight criteria targeted at encouraging the development of standardised documents and use of standardised definitions of key metrics, in order to facilitate a more straightforward and common understanding of securitisations by investors.

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<tr>
<td>Medium</td>
<td>2, 6(b)</td>
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<tr>
<td>Low</td>
<td>1, 5, 6(a), 6(c)</td>
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**Criterion 2** relates to the appropriate mitigation of interest rate and currency risks and the use of derivatives being limited to those used to hedge interest rate and/or currency risk. As drafted the criterion does not require the use of derivatives (e.g. interest rate swaps or caps and floors) but does require disclosure of how interest rate and/or currency risk is mitigated. While this mitigation could be in many forms of credit enhancement (e.g. reserves, subordinated notes, subordinated loans), originators and investors may wish to consider how they will satisfy themselves that the risk has been mitigated.

**Criterion 3** appears to be relatively straightforward. In general consumer and retail finance agreements reference conventional fixed rates or interest rates linked to a market observable rate such as the Bank of England Base Rate, FedFunds or the ECB’s benchmark repo rate. However most UK banks use Standard Variable Rates (SVR), based on the Bank’s own interest rate and liquidity costs. SVRs are used either as a rate to which loans would revert or have already reverted within a pool. As such Banks may wish to consider how to demonstrate that the SVR is a generally used market rate.

**Criterion 4** innocuously covers the topics of cash-trapping and sequential priorities of principal repayment. Originators are required to identify what level of cash-trapping is deemed to be “substantial”. As noted in the discussion on prior criteria, the threshold for material, severe or substantial (in this case), will require an appreciation of the transactional environment in which the threshold decision is being made. Is it appropriate for a cash-balance representing [5%] of the asset portfolio to have accumulated before it is applied to principal? Demonstration of the appropriate judgement having been made is an area where we anticipate regulators to monitor how market practices evolve. Therefore originators may consider approaches to communicate, to regulators and investors how materiality determinations are made and the integrity of such processes.

**Criterion 7** addresses the desire of regulators for consistency in the definition of key loan performance measures. Reference to “clear and consistent” may relate to consistency of reporting on the securitised portfolio with the originator’s own retained underlying exposures, or to establish a market standard across originators for consistent definitions. The time required to (a) establish market-wide consistent definitions for loan performance metrics and (b) progress this regulatory initiative, to revive securitisation markets and facilitate lending to the real economy, may not be compatible with one another. This indicates that the intention for consistency is focused on metrics across the securitisation programmes of an Originator.

**Criterion 8** covers the communication of how voting rights are structured, in order to enable all investors to understand what rights they have and those of other noteholders. The efficacy of the voting system and allocated rights is something originators may wish to consider deeply, in order to avoid potential for legal recourse by noteholders who find they had not properly understood what the specifics of the voting system were. In this respect, for example, previous trends of dynamic “controlling classes” combined with complicated asset valuation systems may be the type of features originators are hesitant to include in transactions.

**Criterion 6(b)** and the mitigation of a servicer default or insolvency, raises at least two considerations, including who is to be responsible for undertaking the actions determined to be necessary to avert a termination of servicing, and also what early warning indicators should be embedded to facilitate actions being taken on a timely basis. While this criterion reads like a “replacement servicer” requirement, there appears to be allowance to consider the continuity of services subject to the satisfaction of the appropriate decision maker. As such originators may wish to consider carefully how this is documented.

Demonstration of the appropriate judgement having been made is an area where we anticipate regulators to monitor how market practices evolve.
Next steps

**Pace of Regulatory Change** – The pace of change in prospective regulatory requirements has been relatively swift and coordinated across Europe. The ECB, BoE and EBA have all provided considerable thought leadership in the European regulatory forum. Continued global cooperation is likely to be the difference between the return of a deep, diverse and sizeable securitisation market and one that is used by niche capital markets participants without providing meaningful funding to the real economy.

**Implementation timelines** – The revised Basel capital framework for securitisation was published in December 2014, targeted to be implemented by January 2018. The recent publication of the draft Securitisation Regulation by the European Commission could see implementation in H2 2017, although given Basel implementation by 2018, we would expect the implementation date to align with the Basel date. The actual implementation date will depend upon European legislative and parliamentary processes.

**Clarity on attestation requirements** – The most recent BCBS consultative document on STC criteria and capital requirements, outlines that both investors and originators of securitisation transactions, will need to arrive at their own conclusions as to compliance with the criteria. The impetus behind this independent determination by the two sets of agents (originators and investors) is not to undermine the integrity of the existing investor due diligence requirements. Regulators may wish to consider, what expectations they will have of regulated investors and if this has the potential to hinder new investors participating in the securitisation market.

**Operations readiness** – Regulated financial services firms involved in securitisations, for example as originators or investors ought to consider what, if any, adjustments need to be made to their existing operational capabilities to meet regulatory requirements. Compliance with existing requirements such as, but not exhaustively, investor due diligence, risk retention and portfolio loan-by-loan disclosures could mean that incumbent participants in the securitisation market may need to make smaller adjustments to their existing processes.

New entrants to the securitisation market, both investors and originators may benefit from a clearer and more settled set of regulatory requirements, but they will need to recognise that these may be different to when they had previously accessed the securitisation market.

Examples of particular priorities may include, amongst others, (a) ability to supply historical performance data for assets similar to securitised exposures, (b) disclosure of analysis undertaken to satisfy homogeneity requirements, (c) collate evidence demonstrating institutional and/or management experience of originating particular asset types, (d) development of consistent definitions for use in portfolio performance metrics.

**Monitor investor demands/concerns** – Originators and Sponsors of securitisation transactions should engage with investors in order to consider adjustments needed to new transactions. As per the BCBS RSW Consultation Document published in November 2015, regulatory policy is evolving to not only place the onus of “attestation” on the issuing/originating entities, but also identifying the on-going requirements to undertake comprehensive investor due diligence. The provision of clear and discernible disclosures is essential for the effective implementation of the STS criteria. Development of agreement or consensus between originators and investors, in the pre-implementation phase of the STS criteria could be a meaningful engagement to facilitate a smooth transition to the new securitisation framework.

**Adjustments to Legal documents** – As seen through a number of criteria spanning across the three limbs of the STS effort, there is a common vein to ensure clarity of documentation relating to how the structure operates, the roles and responsibilities of parties with fiduciary duties. Originators/Sponsors may consider laying the ground work to ensure that such considerations are not being made for the first time during the pre-issuance structuring phase of a transaction after the regulatory requirements are implemented.
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