Simple, Transparent and Standardised Securitisations: All Clear Now?

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> **Key points**
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> - Simple, Transparent and Standardised securitisations give investors significant regulatory capital advantages.
> - Despite welcome guidance from regulators, there are still challenges in meeting the STS criteria, both for legacy and new securitisations.
> - For new securitisations, transaction parties should consider at the outset whether it is the appropriate regime for them.
> - The jurisdictional limitations in the STS regime mean that it could be significantly impacted in a 'no deal' Brexit scenario.

It has been six months since the new EU Securitisation Regulation, together with amendments to the Capital Requirements Regulation (the CRR), created a new framework for certain simple, transparent and standardised term securitisations and asset-backed commercial paper programmes (collectively, STS securitisations). Unlike other provisions of the Securitisation Regulation, such as risk retention, due diligence and transparency (covered in our recent client briefing), which apply to all securitisations, the STS regime is optional. Effectively, there are now two different classes of EU securitisations: STS and non-STS, differentiated on the basis of whether or not they meet the STS criteria, the former giving credit institution and insurance company investors significant regulatory capital advantages relative to the latter. In this briefing we consider how the STS regime is operating and how it may be impacted by Brexit.

The STS criteria

The STS criteria contained within the Securitisation Regulation are separated into more than 50 different items organised into three categories of requirements relating to 'simplicity', 'standardisation' and 'transparency'. The criteria include requirements relating to the underlying assets (such as asset sale, asset homogeneity, origination standards and creditworthiness of the underlying debtors), disclosure and verification (such as documentation contents and clarity, external verification of underlying exposures, provision of a liability cash-flow model and provision of documents to potential investors prior to pricing) and transaction structure (such as risk retention compliance and interest rate and currency risk mitigation). Because the criteria primarily relate to the process by which the transaction is structured rather than the underlying credit quality of the assets involved, there should be no implication that an STS securitisation is free of risk, but rather that a prudent and diligent investor will better be able to analyse and price the risk involved.

Given the regulatory capital advantages accorded to STS securitisations, it may be advisable for originators to have them in mind even at the product-design stage if potential STS financing or refinancing is envisaged.

The STS criteria are intentionally designed so that certain asset classes and structures will never be able to meet them. These include securitisations with managed portfolios of assets (e.g. CLOs and CDOs), residential mortgage portfolios including 'self-certified' loans or certain types of credit-impaired obligors, CMBS (which will not be able to meet the homogeneity criteria) and synthetic securitisations (though the Securitisation Regulation envisages that an STS framework for balance sheet synthetic securitisations may be created in due course).

Interpreting the STS criteria

On their face, many of the STS criteria are vague and therefore potentially open to different interpretations.

In an attempt to avoid divergent practices, the EBA has published guidelines relating to their interpretation. The EBA may in due course complement the guidelines with recommendations to cover particular aspects arising from the practical application of the STS regime. In relation to the homogeneity of assets criterion, the European Commission has recently approved the homogeneity regulatory technical standards (homogeneity RTS). It is envisaged that these will enter into force later this year without further substantive changes being made. Considered cumulatively, compliance with the STS criteria, the EBA guidelines and the homogeneity RTS is likely to be significant regulatory challenge for many market participants. Fortunately, in relation to the EBA guidelines and the homogeneity RTS at least, the style of regulation is more pragmatic and principles-based than prescriptive, which may reduce the compliance burden.

Applying the criteria in practice: new and legacy transactions

Securitisations issued prior to 1 January 2019 may benefit from the STS designation provided that they meet the STS criteria, though in order to make the regime workable several of the criteria will need to be assessed only at the time of the STS notification, rather than on issuance. In addition to meeting the STS criteria, legacy transactions seeking STS designation are (unlike other legacy transactions) also required to comply with the transparency provisions of the Securitisation Regulation, which may present as many difficulties as the STS criteria themselves.

A body of precedent and market understanding of the STS criteria is developing slowly, so a number of the STS criteria still require the parties to reach consensus as to how they apply in practice. Taking residential mortgage backed securitisations for example, in the case of exposures transferred by means of assignment it is not always easy to judge whether the typical ‘perfection trigger’ requirements already included in market standard securitisation documentation need to be tightened to reflect tests for ‘severe deterioration in the seller’s credit quality’ or whether the ‘breach of obligations’ by certain parties trigger can be qualified by materiality. In circumstances where a pool of exposures has been purchased from an original lender, there is a question as to the level of diligence required by the originator in order to satisfy the ‘to the best of the originator’s knowledge’ requirement that the portfolio does not include certain credit-impaired obligors. These questions are not currently answered directly by the EBA guidelines and in order to answer them, it may be necessary for market participants to seek guidance from the EBA directly.

Some other criteria are relatively easier to meet. Again, taking RMBS as an example, because of the way the homogeneity RTS operate, RMBS portfolios only need to meet one of the homogeneity factors rather than all of them. In the case of UK RMBS for example, this means that a mixed portfolio comprising a range owner-occupier and buy-to-let mortgages governed by English and Scots law, which might not able to satisfy either the ‘jurisdiction’ or the ‘type’ homogeneity factors, might still meet the homogeneity criterion if the portfolio can satisfy the ‘ranking of security rights’ homogeneity factor.

STS notifications and reliance

Originators, sponsors and SSPEs are required jointly to notify ESMA, national competent authorities and investors that a securitisation meets the STS criteria, by means of ESMA’s standardised template, and designate among themselves a contact point for investors and competent authorities. The STS notification must include an explanation of how each criterion has been met (appropriately reflecting the EBA guidelines) for publication on the ESMA website. If a securitisation stops meeting the STS criteria, the originator and sponsor are required immediately to notify ESMA and competent authorities and also investors (via the ESMA transparency templates). Securitising parties who breach their STS obligations will be subject to administrative sanctions and potentially also criminal sanctions, to be formulated by local competent authorities (which may therefore differ from member state to member state). Securitising entities have a grace period of three months to rectify good faith erroneous STS designation and during this time the securitisation will continue to be included within the ESMA list of STS securitisations.

Although the STS notification appears at first sight to be a helpful checklist for investors, there is an open question as to the level of reliance an investor may place on it. The text of the Securitisation Regulation states that ‘institutional investors may rely to an appropriate extent on the STS notification… and on the information disclosed by the originator, sponsor and SSPE on the compliance with the STS requirements, without solely or mechanistically relying on that notification or information.’ Because this text appears in the context of the requirement for an investor to do a due diligence assessment rather than a mere verification and because the text does not refer simply to the STS notification but also to other information (which arguably includes the transaction documents, any offering document and the underlying loan level data), it may be that investors will feel compelled to check that the STS notification is consistent with the other information, which will increase costs. This debate can translate into extensive risk factor disclosure within prospectuses and extensive negotiations over the content of indemnities in subscription agreements.

While the STS regime does not include any specific penalties for an investor who invests in a securitisation in reliance on an STS notification without having undertaken an appropriate due diligence exercise, it is possible that such an investor may not be able to recover the full value of any loss incurred from the securitising entities and would also be subject to additional regulatory capital risk weights on their investments from competent authorities under sectoral legislation.

Third party verifiers

There is a specific regulatory framework for the authorisation and supervision of third party verifiers of the STS criteria. The Securitisation Regulation does not impose liability on third party verifiers for incorrectly verifying compliance with the STS criteria, so that responsibility remains with the securitising entities. However, third party verifiers may be subject to other local statutory and tortious heads of liability in relation to their verification. A majority of the securitisations which have received the STS designation to date have used a third party verifier in order to give additional comfort to originators and credibility to sponsors.

Location of STS securitising entities

Unlike the general requirements of the Securitisation Regulation that apply to all securitisations and allow originators, sponsors and SSPEs to be established in third countries, the STS designation is only available if each of the originator, any sponsor and each SSPE is established in the EU. There is no requirement that the underlying assets are originated in the EU (indeed, the criteria specifically refer to third country credit-granting regimes) and there is no requirement that the investors in STS securitisations are EU established or authorised. The Commission has been mandated to present a report by 2022 that shall include an assessment over whether to introduce an equivalence regime for third-country securitising entities.

The Brexit factor

Although as a matter of politics the timing and outcome of Brexit remain very unpredictable, the legal position is much clearer. If the UK leaves the EU by way of the withdrawal agreement (a ‘deal Brexit’), the EU STS regime will continue to be directly applicable in the UK in the same way that it currently is, with market participants being subject to all the same rights and obligations until at least the end of 2020, via the UK legislation implementing the withdrawal agreement. If the UK leaves the EU without the withdrawal agreement being in place (a ‘no deal Brexit’), the Securitisation Regulation (together with its various binding technical standards) will be on-shored into UK domestic legislation via the EU Withdrawal Act 2018, creating a parallel UK STS regime.

The UK Government has made some significant adaptations to the EU STS regime in order to try and make it work for the UK. In order to receive the UK STS designation, it will be necessary for the sponsor and originator to be established in the UK, but the issuer may be established overseas. All securitisations recognised by the EU as STS prior to Brexit and during the subsequent two-year period will continue to be recognised as STS for UK regulatory capital purposes. This means that UK-established credit institution and insurance company investors will continue to benefit from favourable regulatory capital treatment if they invest in EU STS securitisations just as they will if they invest in UK STS securitisations. While in our view these adaptations are welcome and point in a liberal direction, they could have gone further. We do not see any compelling reason why there should be a requirement that the sponsor or originator should be established in the UK or why the recognition of EU STS for UK regulatory capital purposes should be time-limited.

The EU has not confirmed the approach that it would take to STS securitisations with a UK-nexus post-Brexit. Given the variety of approaches that the EU is taking to different parts of financial services legislation, it is not possible to predict whether or not STS securitisations for which at least one of the sponsor, originator or issuer is a UK-established entity will continue to be considered STS for EU regulatory capital purposes. This means that there is an additional level of regulatory risk for EU27-established investors in existing UK STS securitisations.

Because both the EU and the UK STS regimes contain jurisdictional limitations for securitising entities, there are challenges to structuring a transaction that could, in the longer term, benefit from both the EU and the UK STS regimes. In the case of an asset portfolio created by a UK-entity, one solution might be to incorporate an EU27 holding company to retain risk (ensuring that this entity complies with the 'substance' requirements of the risk retention RTS) and use an EU27 SSPE. Such a structure would meet both the UK and the EU jurisdictional limitations. The originator would be the EU holding company and a 'limb (b) originator' for EU STS and risk retention purposes as well as for UK risk retention purposes whereas it would be the UK original lender and a 'limb (a) originator' for UK STS purposes.

We are not aware of this structure being tested and it is unclear whether recent STS securitisations with a UK nexus have each been structured with Brexit in mind. It might be the case that there is a sufficient UK investor base for each such deal such that the question only arises in a theoretical way. Alternatively it might be the case that EU investors judge that they would be able either to sell their investment to a UK investor or to book their investment via a UK-established group entity in a no-deal Brexit scenario.

The choice: to STS or not to STS?

The original policy intent of the European Commission was that, by differentiating STS securitisations from structures which are unable to meet the STS criteria and incentivising investment in the former over the latter, European securitisation markets would be restarted on a more sustainable basis. It is too soon to judge whether or not this was the correct approach. On one view the 'universal' aspects of the Securitisation Regulation are now sufficiently stringent to ensure that the European securitisation markets are sustainable even in the absence of the STS regime (such that all securitisations compliant with the new Securitisation Regulation should benefit from the regulatory capital treatment afforded only to STS). There is also a risk that the STS regime is too binary: effectively if a transaction is unable to meet one of the STS criteria there is no advantage to having regard to any of them.

This presents market participants with some questions at the start of every transaction. Is it going to be technically possible for the transaction to meet the STS criteria? And, if so, do the regulatory capital benefits (in the case of investors) and any resultant pricing advantages (in the case of originators) outweigh the costs of meeting the additional regulatory hurdles? Decisions here tend to be extremely transaction specific: some originators may not be able to meet one of the STS criteria (for example, because some of the underlying obligors are in default or have an adverse credit history). Other originators take the view that there is sufficient non-STS investor appetite for a transaction which has strong credit-support and for high quality underlying receivables. It will be important to ensure that, as some market participants have worried, a stigma does not grow up around non-STS securitisations (e.g. that they are necessarily complex, opaque and full of esoteric risks), as this would be inaccurate and bad for originators and investors.

The first six months of the STS regime have been somewhat slow, but this is likely to be as much due to macro-economic factors, the slow adoption (and consequential uncertainty) of the various secondary measures underpinning the STS regime and the absence of market understanding as to how to make the regime work rather than be a problem inherent in the STS regime itself.

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