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WHITE PAPER

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THE EUROPEAN SECURITISATION REGULATION: THE COUNTDOWN CONTINUES...

Draft Regulatory Technical Standards on the Homogeneity of the Underlying Exposures in Securitisation

Regulation (EU) 2017/2402, which lays down a general framework for securitisation and creates a specific framework for simple, transparent and standardised securitisation ("Regulation"), came into force on 18 January 2018 and will apply to European credit institutions, insurance companies and pension funds as well as alternative investment fund managers from 1 January 2019 onwards. The Regulation tasks the three European supervisory authorities with developing regulatory technical standards and implementation technical standards for a number of key areas addressed in the Regulation.

This Jones Day *White Paper* summarizes the draft regulatory technical standards on the homogeneity of the underlying exposures in securitisations under Articles 20(14) and 24(21) of the Regulation as proposed by EBA in its Consultation Paper of 15 December 2017 (EBA/CP/2017/21).

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Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation ("Regulation") came into force on 18 January 2018. It promotes two purposes: first, the harmonisation and consolidation of certain key elements in the European securitisation market across the financial industries and, second, the creation of a specific legal framework for simple, transparent and standardised ("STS") securitisations. The concept of STS securitisations has been introduced following the strong request of market participants for a recalibrated risk weighting regime that distinguishes between "normal" securitisations and securitisations that meet certain quality standards. The Regulation will apply to credit institutions, insurance companies and pension funds as well as alternative investment fund managers from 1 January 2019 onwards.

The Regulation tasks the three European supervisory authorities, the European Securities and Markets Authority ("ESMA"), the European Banking Authority ("EBA") and the European Insurance and Occupational Pensions Authority ("EIOPA") with developing regulatory technical standards and implementation technical standards for a number of key areas.

In a series of Jones Day *White Papers* we will provide an overview of the various consultation papers and the status of the draft technical standards published by the mandated European supervisory authorities. In three previous Jones Day *White Papers* we focused on the draft technical standards (i) on disclosure requirements to be fulfilled by originators, sponsors and securitisation special purpose entities in securitisation[1], (ii) on operational standards for securitisation repositories data collection, data aggregation and comparison, data access, and procedures to verify completeness and consistency of information[2] and (iii) on content and format of the STS notification under the Regulation[3].

This Jones Day *White Paper* focuses on EBA's consultation paper (EBA Consultation Paper of 15 December 2017 – EBA/CP/2017/21) for draft regulatory technical standards on the homogeneity of the underlying exposures in securitisation transactions under the Regulation ("Consultation Paper").

LEGAL BACKGROUND AND TIMETABLE

Article 20(8) (for non-ABCP securitisations) and Article 24(15) (for ABCP securitisations) of the Regulation require that the "securitisation be backed by a pool of underlying exposures that are homogeneous in terms of asset type, taking into account the specific characteristics relating to the cash flows of the asset type including their contractual, credit-risk and prepayment characteristics. A pool of underlying exposures shall comprise only one asset type" ("Homogeneity Requirement").

Not only is the Homogeneity Requirement one of the requirements for identifying simple, transparent and standardised (STS) securitisations enabling investors to perform robust due diligence and facilitating the assessment of underlying risks, it also goes to the heart of each securitisation transaction: for originators and sponsors, because it sets the boundaries for the composition of the securitised portfolio in STS securitisations; for investors, because it is designed to facilitate the assessment of the pool of underlying exposures on the basis of common methodologies and parameters and based on the understanding that the pool consists of underlying exposures with similar risk profiles and cash flow characteristics.

Due to the paramount importance of the Homogeneity Requirement, Articles 20(14) and 24(21) of the Regulation expressly mandate EBA to develop draft regulatory technical standards for the homogeneity of underlying exposures in securitisations ("Draft RTS") in addition to the general guidelines and recommendations on the harmonised interpretation and application of the STS criteria to be adopted by EBA, in close cooperation with ESMA and EIOPA, by 18 October 2018[4].

The deadline for the submission of the final Draft RTS to the European Commission is 18 July 2018. The feedback period for the Consultation Paper ended on 15 March 2018.

HOMOGENEITY CRITERIA FOR UNDERLYING EXPOSURES

Taking into account the objective of the Homogeneity Requirement (which is to allow the investor to assess the underlying exposures in the pool, the underlying risks—in particular credit risks—and cash flow characteristics, on the basis of common methodologies and parameters) Article 1 of the Draft RTS states that the underlying exposures in a securitisation "shall be deemed to be homogenous" where they have similar risk profiles and cash flow characteristics, enabling the investor to assess the underlying risks on the basis of common methodologies and parameters". Article 1 then goes on to list the conditions to be satisfied in order to qualify as a homogeneous pool. Accordingly, the underlying exposures must:

- have been underwritten according to similar underwriting standards, methods and criteria;
- be serviced according to uniform servicing procedures with respect to monitoring, collection, administration and allocation of cash receivables;
- all fall within the same asset category; and
- take into account the relevant risk factors from among those that need to be considered for each asset category.

If all of the above conditions are fulfilled, the underlying exposures shall be deemed to meet the Homogeneity Requirement. EBA takes the view that it is unnecessary to distinguish between exposures in non-ABCP securitisations and exposures in ABCP securitisations, i.e. the same conditions apply to both types of securitisation.

Underwriting Standards

The requirement of having similar underwriting standards is not to be confused with the STS criterion set out in Article 20(10) of the Regulation, which requires that the "underlying exposures shall be originated in the ordinary course of the originator's or original lender's business pursuant to underwriting standards that are no less stringent than those that the originator or original lender applied at the time of origination to similar exposures not being securitised".

The requirement is based on the rationale that exposures that have been originated by applying the same or substantially similar underwriting standards, methods and criteria are likely to show the same risk profile and cash flow characteristics that are shown by exposures originated on the basis of non-uniform underwriting standards.

This approach appears sensible in securitisations with underlying exposures consisting of one single asset class (e.g., non-residential mortgage loans where the loans and mortgages are originated based on the same underwriting criteria, such as credit application process, credit scoring and property valuation). However, how is this approach to be applied in transactions with different sub-pools (which themselves are based on the same underwriting standards)? Take as a common example the securitisation of a pool of auto loans and leases (which actually forms a permitted asset category under Article 2 of the Draft RTS): would the same underwriting standards have to apply to all loans and leases as a whole, or would it be sufficient, if each asset category were based on the same underwriting standards? The Draft RTS do not appear to favour the latter approach. Also, it is doubtful whether a portfolio of SME or corporate loans (the terms of which are in each single case tailor-made to fit the borrower and its financing needs) could ever satisfy this requirement.

In this context, the term "similar" leaves room for interpretation (or doubt) in respect of the Homogeneity Requirement. Does it merely imply that the exposures have been originated based on a set of similar underwriting standards, methods and criteria? Or does it go further to suggest a pooling of the same credit risk[5]? The latter would certainly go beyond what is considered homogeneous.

In our view this requirement could be simplified without compromising on its objective: to satisfy the Homogeneity Requirement it would be sufficient to ask that the underlying exposures have been originated on the basis of existing underwriting standards. This would mean that a securitisation transaction could include various asset classes (to the extent they constitute a permitted asset category), as long as each sub-portfolio is based on the same underwriting standards.

Uniform Servicing Procedures

To satisfy the Homogeneity Requirement the underlying exposures in the pool must be serviced according to uniform servicing procedures, because the "servicing of the securitised exposures, which includes monitoring, collecting, managing and distributing cash receivables and providing related cash and payment services, has a substantial impact on the cash flow expected to be received from the underlying exposures and is therefore one of the core aspects of investors' assessments and due diligence analysis"[6].

There is no question that the quality of the servicing impacts the cash flow and, consequently, the payments to investors. However, whether or not the underlying exposures are homogeneous is not a consequence of the servicing activity; rather it is the other way round—the existence of uniform servicing procedures are a consequence of the existence of homogeneous exposures.

In addition, similar to what has been said above in relation to the underwriting standards, different servicing standards and procedures apply to different asset classes (take the above example of auto loans and leases).

Since the quality, process and continuity of the servicing are addressed in other places of the Regulation, e.g., Article 21(7) and (8) of the Regulation, it does not appear necessary to make the servicing standards part of the Homogeneity Requirement.

Same Asset Category

STS securitisations must contain exposures of the same asset category. Article 2 of the Regulation provides for a non-exhaustive list of types of exposures that will always be deemed to fall in one and the same asset class. Article 2 lists the following asset categories:

- residential property loans;
- commercial property loans;
- consumer loans and leases;
- loans and leases to SMEs;
- auto loans and leases;
- credit card receivables; and
- trade receivables.

The above categories represent the currently most common asset classes prevailing in the EU and satisfy the requirements for asset-backed securities to be eligible as collateral in the Eurosystem credit operations as well as the criteria applied under Solvency II and for level 2B securitisations in the context of the liquidity coverage ratio[7]. However, EBA makes it clear that for the benefit of financial innovations and an increased asset diversification the list of asset categories set out in Article 2 of the Regulation is meant to be non-exhaustive.

Risk Factors

Over and above the requirement of having similar underwriting standards and uniform servicing procedures for assets within one and the same asset category, Article 1(d) of the Draft RTS additionally requires that the underlying exposures take into account the relevant risk factors from among those that need to be considered for each asset category in accordance with Article 3, with a minimum of one risk factor.

The so-called risk factors, which are listed in Article 3(2) of the Draft RTS, are designed to serve as an additional "micro" filter that is to be applied to the exposures of the same asset category. EBA takes the view that, because of the relatively broad scope of the asset categories, "belonging to one such asset category does not render the underlying exposures sufficiently homogeneous"[8]. This means that exposures that by their type and nature belong to the same asset category may, as a result of the application of the specific risk factor(s), nevertheless not be considered homogeneous.

Article 3(1) of the Draft RTS references the relevant risk factors to each of the asset categories specified in Article 2 of the Draft RTS. Article 3(2) provides for a specification of the risk factors. To provide an example: for the asset category "residential mortgage loans" the risk factors "ranking", "type of property", "repayment structure", "jurisdiction of property" and "governing law" would need to be considered, whereas all other risk factors would either already be embedded in the asset category (e.g., type of obligor or financing purpose) or be irrelevant or non-applicable (such as "industrial sector of the seller"). Amongst all risk factors that need to be considered, only those risk factors that are "relevant" need to be taken into account. In the above example of residential mortgage loans, the risk factor "jurisdiction of property" may be irrelevant in a transaction where all properties are located in one jurisdiction, whereas the risk factor "repayment structure" may be relevant due to the fact that the underlying loans provide for different amortisation structures. For a better overview the Consultation Paper contains a matrix mapping each asset category with the risk factors and their relevance[9].

According to Article 1(d) of the Draft RTS at least one risk factor needs to be considered. For the asset category "'trade receivables' this is the risk factor 'industrial sector of the seller'". However, trade receivable securitisations (in particular ABCP securitisations involving trade receivables) involve only one seller or only sellers of the same group of companies (which normally work in the same industry sector). In the context of the Homogeneity Requirement there is, in our view, no point in trying to distinguish the underlying exposures between the various industrial sectors. This would only be relevant, if the risk factor were linked to the industrial sectors of the obligors. As an additional observation, the Homogeneity Requirement is, in our view, of less importance in fully supported ABCP programmes, since the risk associated with non-homogeneous exposures is mitigated by the full liquidity support provided by the sponsor (the existence of the which is a requirement for STS securitisations)[10].

Whereas EBA believes that referencing each asset category to specific risk factors adds more clarity and facilitates the assessment of the Homogeneity Requirement, it is almost inevitable that the application of risk factors in addition to the other Homogeneity Requirements will have a significant impact on the composition of the securitisation portfolios and on the diversification of securitised assets. This will adversely affect those securitisations that currently dominate the European securitisation market, namely auto loan, auto lease and consumer loan securitisations. Currently, these securitisation structures provide for some flexibility for underlying exposures with different amortisation profiles and repayment schedules, which when applying the risk factor "repayment structure", might no longer satisfy the Homogeneity Requirement. As a result, for STS securitisations the underlying exposure pools may need to be regrouped and cut into smaller, separate and less diversified tranches (with all the related negative (pricing) effects).

ALTERNATIVE APPROACH

EBA itself seems to be uncertain about the two-step approach, i.e. applying the risk factors in addition to the requirement of having similar underwriting standards. For this reason, EBA seeks stakeholders' views on an alternative approach that merges the two criteria into one single criterion requiring that the underlying exposures have been underwritten according to similar underwriting standards, methods and criteria, which duly take into account the risk factors. All the risk factors shall be taken into account, unless adequate justification is produced that a specific risk factor is not considered relevant in order for the underlying exposures to have similar risk profiles and cash flow characteristics and to enable the investor to assess the underlying risks on the basis of common methodologies and parameters.[11]

According to EBA, this approach would:

- possibly reduce the complexity of the Homogeneity Requirement, as it would reduce the number of determining criteria; and

- offer more flexibility to originators with respect to the way and method of how to take into account the risk factors in the origination process; but

- mean less certainty for investors, as it would make the assessment of the pool and of the reflection of the risk factors in the underwriting, as part of the due diligence, more complex.

It is questionable whether the alternative approach really means offering a less complex solution. Moving the risk factors to the level of the underwriting standards would most likely mean that asset pools that are considered homogeneous for purposes of the underwriting standards but are not considered homogeneous after taking into consideration the risk factors, would now already fail to meet the criterion of similar underwriting standards.

In our view, the application of risk factors (either as a separate criterion or as part of the underwriting standards) to (otherwise) homogeneous asset categories is not required to achieve the objective of the Homogeneity Requirement. To enable investors to perform robust due diligence and to facilitate the assessment of underlying risks it is imperative to have adequate disclosure and information tools in place. This goal is achieved by Articles 7(1)(a) and 7(1)(e) of the Regulation which require originators, sponsors and SSPEs to provide information on the underlying exposures as well as quarterly / monthly investor reports. Based on the information provided as part of the mandatory disclosure and the STS notification process, investors will be enabled to perform their due diligence on the underlying exposures and to assess the underlying risks. There should be no need to create additional restrictive features on the way to compliance with the STS criteria.

In the next Jones Day *White Paper* we will take a closer look at EBA's Consultation Paper regarding draft regulatory technical standards specifying the requirements for originators, sponsors and original lenders relating to risk retention pursuant to Article 6(7) of the Regulation[12].

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ENDNOTES

1 ESMA Consultation Paper of 19 December 2017 - ESMA33-128-107, *see* Jones Day *White Paper*.

2 ESMA Consultation Paper of 19 December 2017 - ESMA33-128-107, *see* Jones Day *White Paper*.

3 ESMA Consultation Paper of 19 December 2017 - ESMA33-128-33, *see* Jones Day *White Paper*.

4 *See* Articles 19(2) and 23(2) of the Regulation.

5 Paragraph 12 b. of the Consultation Paper refers to „underlying exposures exhibit similar risk profiles and cash flow characteristics".

6 Paragraph 12 c. of the Consultation Paper.

7 Art. 13 of the LCR Delegated Act (Commission Delegated Regulation 2015/61), and Art. 177 of the Solvency II Delegated Act (Commission Delegated Regulation 2015/35).

8 Paragraph 25 of the Consultation Paper.

9 Page 15 of the Consultation Paper.

10 Article 25(2) of the Regulation.

11 Page 25 of the Consultation Paper.

12 EBA Consultation Paper of 15 December 2017 (EBA/CP/2017/22).