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Structured Capital Markets

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Client Alert

The EU framework for Simple, Transparent and Standardised (STS) Securitisation - Part 1: An Overview

The recent conclusion of negotiations on the European legislative framework for "STS" securitisation ends a long period of uncertainty and unrest for the market. Now that the framework has been largely finalised (save for official publication of the final legislative texts), this series of Client Alerts will examine the key aspects of the framework in further detail during the 18 months until its implementation in 2019.

This Part 1 of the series provides a status update and an overview of some high-level issues as well as a comparative analysis of the various risk-weights, floors and caps under the STS framework with the global equivalent under Basel III and the existing European regime. We also round-up some of the key regulatory discussions amongst market participants attending the recent Global ABS Conference 2017 in Barcelona, where the progress made towards the framework's completion was welcomed.

Simple, Transparent and Standardised (STS) Securitisation

Background

Since the original legislative proposals were issued in late 2015 as a core part of the EU Capital Markets Union (CMU) project, the "trialogue" of the European Commission, Council and Parliament have been negotiating the details of two new Regulations which together represent the EU's objective of building a sustainable securitisation market in the wake of the global financial crisis. "Compromise texts" of both Regulations were published at the end of June 2017 and have now been approved (by the Council's Permanent Representatives Committee, COREPER, and the Parliament's Economic and Monetary Affairs Committee, ECON). They will then be adopted by the Parliament in a plenary session (which we understand has been scheduled for 23 October 2017), and then formally published in the Official Journal of the EU (the OJ). While the Regulations will technically enter into force shortly after OJ publication, compliance with the package will not be required until 1 January 2019.

Requiring securitisations to meet high standards of simplicity, transparency and standardisation, the framework also allows (bank) investors to benefit from lower capital requirements for their investments in such STS deals (as compared to non-STS deals). The STS legislative package comprises:

- A "**Securitisation Regulation**", which sets out EU-wide securitisation rules (including a re-casting of some existing risk-retention, due diligence and transparency provisions and the creation of some new requirements), establishes the new framework for STS securitisation, including the 50+ STS Criteria and makes consequential amendments to current EU legislation (see compromise text); and

- A "**Regulation Amending the Capital Requirements Regulation (CRR)**", which sets out the (differing) capital treatment of STS and non-STS securitisations, the "hierarchy" of capital calculation methodologies and risk-weight floors and caps (the "Regulation Amending CRR") (see compromise text).

Following agreement being reached on the proposed STS package, recent discussions (including those held during the Global ABS Conference 2017) have turned to examining the final detail of the legislative measures.

Polling results during the *Global Regulatory Watch* panel at Global ABS settled on a largely neutral response to a question gauging how optimistic participants were that the finalised STS framework would revive the European securitisation market. Although this reflected earlier results from a *Regulatory Headwinds* panel poll on whether STS is a game-changer for the market (with 100% voting 'maybe'), it also highlights the ongoing uncertainty over the full scope and impact of the final package, particularly since the next 12 months will see the development of the additional, detailed technical standards and guidance that will form part of the overall STS framework.

High-level issues

The outcome on several key issues on which the market was awaiting clarity is as follows:

- **Risk-retention:** the existing level of risk-retention remains set at 5%, despite the European Parliament having sought to increase that figure to 10% (or even 20% and higher in some cases, depending on the method of retention used) in the face of strong industry lobbying. The final provisions mandate the European Systemic Risk Board (ESRB) to keep the 5% level under continual review which may allow for discussions to be opened on adjusting the retention rate (at least for some retention methods) in future. Despite the addition of this regular-review clause, it is widely anticipated that the ESRB's role in this regard will ultimately be a laissez-faire one, and the market has expressed relief as to the outcome of negotiations on this point.

- **Third party certification of STS status:** third parties *may* "assist" in verifying STS compliance, with the STS rules placing liability for the STS designation squarely with the originator / sponsor / SPV. There are mixed views on the significance the market will attach to such a third party certification (some arguing that it is merely a useful "check", others seeming more willing to attach some degree of confirmatory status to the third party's check). While some form of third party verification of a deal's purported STS compliance was expected within the framework - and is indeed helpful for the industry, to the extent such a service is readily available and supplied by credible, approved providers - the precise operation of these provisions, and their interaction with the sanctions provisions, will be crucial.

- **Third countries and equivalence:** the STS framework will exclude securitisations where the originator / sponsor / SPV is not established in an EU Member State, with no specific "equivalence" regime being introduced at this stage. This issue is thrown into sharp relief in the context of the UK becoming a "third country" (i.e. a non-EU Member State) post-Brexit. Even though many UK originators appear comfortable that they have a strong investor base outside the EU, the absence of an STS equivalence regime could reduce the attractiveness of securitisations completed under third country regimes (or indeed cross-border deals), lead to a fragmented market, and act to further disrupt the global level playing field.

- **The hierarchy:** under the Regulation Amending CRR, banks will apply the three-tier hierarchy of approaches to measuring capital requirements, consisting of:

    - the "Securitisation Internal Ratings-Based Approach" (SEC-IRBA, a formulaic approach based on banks' internal calculations, which is designed to give the most risk-sensitive output);
    - the "Securitisation External Ratings-Based Approach" (SEC-ERBA, which is the only approach based on external ratings and for which risk-weight look-up tables are provided); and

- the "Securitisation Standardised Approach" (SEC-SA, the simplest, least risk-sensitive approach based on a similar formula to the SEC-IRBA).

The original legislative provisions as drafted by the Commission were designed to allow a bank to apply the 3-tier hierarchy in order of risk-sensitivity (SEC-IRBA > SEC-ERBA > SEC-SA). Following conclusion of the trialogue negotiations (during which the Parliament was pushing for the framework to encourage greatly reduced reliance on external ratings), the outcome now appears to be that this hierarchy may be "inverted" in certain circumstances to allow (or require) use of the SEC-SA before the SEC-ERBA. Although this may not necessarily result in negative outcomes, especially given that SEC-ERBA can result in unusual risk weightings, investors note that it is the capital treatment (and not necessarily the designation of STS compliance) that will dictate how attractive securitisation products will be to hold in future.

- **Risk weights, floors and caps:** see the comparative table set out at the end of this Alert for a quick comparison of the various risk-weight floors and maximum capital requirements under the STS framework with those under the existing CRR as well as under the (also recently-finalised) Basel III "Revisions to the Securitisation Framework", which the European STS regime largely follows.

- **Data repositories:** a system of securitisation repositories will be created to hold relevant data on STS securitisations to increase transparency. This was an expected development, but the full detail of this regime will be important to the (multiple) types of entity which may act as a repository, in terms of their application for registration, governance, the detail to be provided by entities seeking an STS designation and other operational standards. A series of Regulatory Technical Standards (RTS) will set out further detail on the operation of the securitisation repository regime.

- **Technical standards and guidance:** the STS package provides for the creation of several sets of RTS and accompanying guidance, to supplement the text of the Regulations. Important areas in which these are required include risk-retention, homogeneity (of asset classes) and disclosure templates. Most of these RTS are required by the text of the Regulations to be introduced within a 6 or 12 month timeframe of the STS package taking effect. Representatives of the European Banking Authority (EBA) have confirmed that the development of RTS is being prioritised and that their development would necessarily involve a (three-month) period of industry consultation and feedback. It is partly for this reason that the implementation date for the full package was pushed back by six months from 1 July 2018. While the market would agree that it is more important to get these RTS right than rush them through, the overall delay to implementation of the entire package is unhelpful, with market participants keenly aware that since *all* of the various aspects of the STS criteria must be met by a transaction, the market needs to know what all of those rules will be (and any delay to the RTS means the market cannot assess the full scope of compliance required).

Timing, detail and implementation

As mentioned above, the final, approved Regulations still need to be published in the OJ and the compromise texts as published will benefit greatly from a tidy-up and some clarifications (by way of example, the EBA is tasked with drafting one of the required sets of RTS by "1 January 2014"). Although the legislative measures, both taking the form of Regulations, would normally take effect 20 days after publication in the OJ, there will be around a 12-month lead time until compliance is required from 1 January 2019. Some outstanding issues have been the focus of further discussions with securitisation industry participants:

- **Legacy transactions:** the treatment of existing (or "legacy") transactions outstanding at the time of the Regulations taking effect, is important. The STS Regulation does not provide specific grandfathering treatment for legacy deals, but there are some limited transitional provisions incorporated into the text which will allow asset-backed securities issued before the STS

Regulations apply that comply with certain of the STS Criteria to be deemed as STS (however, their compliance - albeit with a limited number of the STS Criteria - is required as at the date of issuance). In addition, deals already outstanding on 1 January 2019 may apply currently-existing due diligence and risk retention rules, and some existing RTS provisions until such time as the RTS required under the STS framework have been developed. Now that the treatment for legacy deals is slightly clearer, we expect to work closely with clients in relation to such transactions, to determine the practical impact. In terms of capital requirements, under the Regulation Amending CRR, banks will be permitted to apply the existing CRR framework to securitisation positions they already hold on 1 January 2019 for a transitional period until 31 December 2019.

- **The 50+ STS Criteria:** it was noted during the *STS/STC Compliance* panel at Global ABS that *no* existing, outstanding European securitisation would today meet all of the STS Criteria, and that since many of the Criteria are vaguely drafted, it may prove difficult even to derive the full meaning of each individual requirement. It is generally agreed that additional guidance on the interpretation of the STS criteria will be required to assist with full compliance (on which, please see further below). It is noteworthy that the Criteria themselves received a great deal less scrutiny during the trialogue process when compared with the lengthy negotiations on, for example, risk retention. Part of our series of Alerts on the STS framework will look at the detail of the STS Criteria and any proposed guidance, to help our clients navigate the framework.

- **Overlap with Solvency II:** the punitive capital charges for insurance company investors in securitisations, currently set out in a Delegated Act under the Solvency II Directive, are to be substantially amended under a new calibration that will significantly lower those charges for both senior and non-senior tranches, bringing them more in line with the STS capital requirements for banks. The STS framework provides for these changes to be made under a separate proposal for a new RTS that is expected to follow shortly. It will be important to minimise differences between the various quality "standards" for securitisation now set out in European legislation, including the STS Criteria, the rules for "Type 1" / "Type 2" securitisations under Solvency II, and the standards for securitisations (of varying types) to qualify as "Level 2B" assets under the Liquidity Coverage Ratio (LCR) Delegated Act.

- **Capital impact:** despite the capital charges for STS securitisations being lower than for non-STS transactions, they are widely considered to be still too high to effectively promote investment in securitisation. The same argument now holds for banks as well as insurance companies and investment firms, with the hurdles to investing in securitisation still perceived to be too high despite attempts to address this. Market participants continue to reiterate the widening gap between the regulatory treatment of securitisations and covered bonds, with the latter continuing to benefit from lighter-touch regulation which many feel is not justified. The final detail of the provisions in the Regulation Amending CRR are crucial in terms of determining the actual capital charges for an investment in a particular transaction (again, see the table at the end of this note for further detail on the risk-weightings under each of the "approaches" to measuring capital).

- **Consistency:** the importance of the consistent application, interpretation and mediation of the STS package cannot be ignored. Representatives of the European Supervisory Authorities (ESAs) responsible for helping implement the package (principally the EBA assisted by the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA)) confirmed in the *Global Regulatory Watch* discussion at Global ABS that they would be working closely together in the development of the framework, with working groups already focusing on developing the required disclosure templates (as well as the key RTS and guidance mentioned above). National competent authorities will also have a role to play in interpreting ESA-level guidance and co-operation amongst the various supervisory authorities is widely thought to be key to ensuring consistent application and interpretation of the framework.

- **What's missing?:** some provisions that would have unnecessarily restricted the securitisation market and its participants (and which were largely supported by the Parliament rather than the Commission and Council) have helpfully been negotiated out of the final texts. These include entity-type restrictions on transaction parties (including originators, sponsors and particularly SPEs - although these parties must all be established in the EU to achieve STS compliance), a restriction on investor-types to only "institutional investors" (with retail investors now allowed to participate subject to certain conditions) and the application of onerous disclosure requirements to investors, reporting rules for private transactions, and the requirement that SPEs are set up for the "sole purpose" of securitisation. In addition, the outright ban on "re-securitisation" (not just as eligible for STS treatment but from the entire securitisation framework) has been somewhat watered down by the provision of certain exceptions. As already noted, there are several sections of missing text, text remaining in square brackets and outdated references to drafting deadlines, all of which we expect will be addressed in the final OJ versions of the texts.

The f-word

Market fragmentation is a widely-discussed by-product of the STS initiative. Despite concerns that a two-tier, or multi-tier market will evolve in the short-term, it is also recognised that the securitisation market continually adapts, with new entrants, nascent asset classes and evolving structures becoming increasingly commonplace. Since the STS framework is largely static in nature, its scope may not reflect these developments. The greater involvement of non-banks in the securitisation market is also widely welcomed, not least since it is a stated aim of the overall CMU project to diversify the European financial system beyond bank investment. Since regulators are increasingly looking at securitisations more closely on a case-by-case basis, there is scope to develop a range of 'core' products - this is something that has been seen to date with the natural development of 'silos' in the form of German auto deals, Italian NPL deals, UK RMBS and so on. Indeed, two-thirds of those responding to a poll question in the *Regulatory Headwinds* panel at Global ABS as to whether the STS package would have an adverse effect on the development of, or investor appetite for, *non*-STS transactions, voted 'no'.

Keeping up with the Basel STC project

The Basel Committee noted recently (in its Work Programme for 2017-18) that it will be making some "*targeted adjustments and simplifications … to the securitisation framework*". As many in the industry may recall, the Basel Committee's "Revisions to the Securitisation Framework" were finalised in July 2016 to include the (global) regulatory framework for "Simple, Transparent and Comparable" (STC) securitisation, for implementation from 1 January 2018. Although the European STS framework does not directly follow (nor implement) the global framework, it is broadly similar, and it will be interesting to see which aspects of the framework the Basel Committee plans to amend - a lowering of the global risk-weightings for STC securitisations may result in consequent changes to the European STS framework to align it with the global rules and ensure a level playing field. Indeed, the STC and STS frameworks are aligning further even before their implementation, with the Basel Committee recently issuing a consultation on extending the STC framework to short-term securitisations (i.e. asset-backed commercial paper transactions), which the European STS framework already encompasses.

Looking forward

As mentioned above, until we see the final texts of the Regulations and the accompanying package of RTS, the detail of several important parts of the STS package remains outstanding. Like so much of the regulatory response to securitisation since the global financial crisis of a decade ago, the devil will be in the detail. Since the package provides for a review of the legislation by the Commission within three years, and a review of the operation of the framework by the ESAs within two years (including the possibility of extending the STS framework to synthetic securitisation in future), it is to be expected that it will adapt and develop over the next decade.

Indeed, there are other regulatory developments that may also impact the securitisation market in the near future, not least the recent Commission proposals to amend the European Market Infrastructure Regulation (EMIR) to (amongst other things) re-categorise securitisation special purpose entities (SSPEs) as "financial counterparties" under EMIR. The re-categorisation would mean that SSPEs potentially become subject to margining and other risk-mitigation obligations under EMIR and may be more likely to become subject to the clearing obligation in future. See our recent Client Alert for further detail on this topic, the potential impact of which is currently being assessed in greater detail.

We look forward to providing further updates as the full detail of the STS framework is published in due course. Please feel free to contact the relevant Baker McKenzie lawyer in Europe for further detail.

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Comparative Table: Risk Weight Floors and (Capital) Caps under CRR / STS / Basel III

	Existing CRR *No non-STS vs STS distinction*	**STS / CRR Regs*** Non-STS vs STS *Applies as of 1 January 2019	**Basel III (Revised Sec'n Framework)*** Non-STC vs STC *Applies as of 1 January 2018
Risk-weight floors	3 key approaches under existing CRR: 1. Ratings-Based Method (RBM) (rated positions) 2. Supervisory Formula Method (SFM) (unrated positions) 3. Standardised Approach (SA)	3 key approaches under STS framework: 1. SEC-IRBA (based on internal ratings) 2. SEC-ERBA (based on external ratings) 3. SEC-SA (standard approach)	3 key approaches as per STS / CRR column: 1. SEC-IRBA (based on internal ratings) 2. SEC-ERBA (based on external ratings) 3. SEC-SA (standard approach)
	Article 261 - RBM Senior positions = 7% Re-securitisations = 20%	Article 259/260: SEC-IRBA Note: IRBA calculations based on complex sum involving these inputs: • K_{IRB} - the capital charge had the exposures not been securitised • Tranche Detachment /Attachment points • Number of exposures in pool • Loss-given default (LGD) • Tranche maturity • 'p' (capital surcharge) **NON-STS** (Article 259): Risk weight floor = 15% **STS** (Article 260): Risk-weight floor for senior STS positions = 10% NB: Recital 5: "..15% risk weight floor for all securitisation positions" (this is thought to relate to non-STS)	*Largely mirrors STS / CRR provisions.*
	Article 262 - SFM Note: SFM is a complex calculation spanning a whole page of the CRR All positions floor = 7% Re-securitisations = 20%		Paragraph 114 - STC Under *all three* approaches, risk weights for STC securitisation subject to a floor risk weight of: Senior positions = 10% Non-senior = 15% *Very similar to CRR/STS approach.*
	Article 251 - SA Senior positions = 20% min Re-securitisations = 40% min	Article 261/262: SEC-ERBA (long-term): **Table 2 - NON-STS:** Senior positions = 15% min, depends on tranche maturity (if longer than 1-year, min is 20%). Plus, risk-weights must be no lower than that corresponding to a hypothetical senior tranche of the same deal with the same credit assessment and maturity (Article 261(6)). Mezzanine = 15% min (1-yr) / 70% min (5-yr) **Table 4 - STS:**	Paragraph 68/87 (NON-STC) *Same as for CRR/non-STS -* Floor for senior = 15% Paragraph 68: SEC-ERBA (long-term) NON-STC *Same as for CRR/non-STS - floor = 15%. The look-up tables are exactly the same, both for STS and non-STS.* Paragraph 87 - SEC-SA (NON-STC) *Same as for CRR/STS - Floor = 15%.*

		Senior positions = 10% min, regardless of tranche maturity Mezzanine = 15% (1-yr) / 40% min (5-yr)	
		Article 263/264 - SEC-SA: Note: SA calculations based on complex sum involving these inputs: • 'D' - Detachment point • 'A' - Attachment point • K_A - sum based on RW applicable if exposures not securitised **NON-STS** (Article 263) Senior positions = 15% min **STS** (Article 264) Senior positions = 10% min (plus must use 'p' = 0.5 compared to 1 for non-STS)	
Risk-weight caps (Max risk weight for *senior positions*, i.e. tranches)	Existing CRR provisions not directly equivalent to CRR/STS or Basel III framework, but see: Article 252 An originator or sponsor institution may limit the risk-weighted exposure amounts calculated in respect of its positions in any one securitisation to the risk-weighted exposure amounts which would be calculated for the securitised exposures had they not been securitised, subject to the presumed application of a 150% risk-weight to: (i) items in default; and (ii) "high-risk" items. Article 260 "Maximum risk-weighted	Article 267 "Look-through approach" (1) where composition of the underlying exposures is known at all times, the maximum risk weight is equal to the exposure-weighted average risk-weight on exposures if not securitised (K_{IRB}). (2) Using SA or IRB, max risk weight equals the exposure-weighted average risk-weight applicable … as if not securitised (K_{IRB}). "Mixed pools": If using SEC-IRBA, assign relevant portions of underlying pool to the SA or IRB approach respectively. If using SEC-SA or SEC-ERBA, the maximum risk weight equals the weighted average risk-weight of the underlying exposures under the	Paragraphs 88/89 *Exact same provision as CRR/STS framework.*

	exposure amounts" Where K_{IRB} can be calculated, RWEA calculation is limited to that which would produce an own funds requirement equal to 8% of the RWEAs which would be produced had the exposures not been securitised and were on the balance sheet of the bank.	SA. NB: These maxima do not apply to "re-securitisations" which are subject to a floor risk weight of 100% - Article 269.	
<u>Overall Cap</u> (Maximum capital required for aggregate positions held)		<u>Article 268</u> "Maximum capital requirements" Under any approach: Maximum is equal to the capital requirements that would be calculated … as if the exposures had not been securitised. For mixed pools, calculate the exposure-weighted average of the capital requirements under IRB and SA portions. Maximum capital is the result of multiplying amount above by a 'V' factor depending on proportion of positions held in each tranche. NB: These maxima do not apply to "re-securitisations", which are subject to a floor risk weight of 100% - Article 269.	<u>Paragraphs 90-93</u> *Largely the same approach as for CRR/STS framework.*