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## The STS Criteria Under the New European Regulatory Framework for Securitisation

### Highlights

Since the global financial crisis of 2007-2008, the securitisation market has been struggling to recover. Volumes have decreased and regulatory burden for issuers and investors has frozen the market in an attempt to revitalise the economy through the diversification of funding sources and to promote further integration of the EU capital markets, Regulators issued a new European regulatory framework for securitisations. Under this new regulatory framework, securitisation deals should be considered of "high quality" and therefore have less penalising risk weights if their underlying exposures and the cash flows resulting from them are characterised as simple, if they are transparent with regards to the level of information disclosed to investors and if they have standardised and thus comparable structures.

While there are still remaining areas of ambiguity, in this report, Moody's Analytics will try to address some of the main concerns of the market and dig deeper into the criteria set within the STS requirements.

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## Clarifications for market players

### Labelling

Although there are some institutions willing to offer this assessment for originators, STS is a self-certification overseen by national competent authorities and with reporting requirements set by ESMA, so, ultimately, responsibility on the accuracy of the information falls exclusively under the originator. From an investor perspective, institutional investors may rely on the information disclosed by originators regarding compliance with STS requirements, but not without their own due diligence. The responsible competent authority does not check the STS labels, but imposes sanctions if requirements are not met.

### Eligible Asset Categories

- » Residential mortgages
- » Commercial mortgages
- » Credit facilities to individuals for personal, family and household consumption purposes
- » Credit facilities to enterprises and corporates (including SME)
- » Auto loans and leases
- » Credit card receivables
- » Trade receivables

Assets categorised as esoteric are not eligible for the STS label. Examples: non-performing loans (NPLs), insurance premiums or whole business securitisations (WBS).

### ESMA Templates

Last August, ESMA published the disclosure requirements under the new securitisation framework. Originators shall send regularly to the market loan level data, investor reports, inside information and "significant events" according to ESMA templates through certified securitisation repositories. It is important to note that the underlying exposures templates specific to each asset class are not related to the STS eligibility criteria; instead they are a requirement for all transactions, including those asset classes not eligible for the STS designation. Although this has not been officially defined, ESMA declared the implementation of the reporting arrangements could potentially have a transition period from 15-18 months, during which the degree of compliance should gradually increase.

### Brexit

What happens to UK deals after Brexit? No one really knows, but if no deal is reached, UK deals might not be labelled STS and hence might require correspondingly higher regulatory capital compared to securitisations of similar quality among EU members, until British Regulators institute a similar regulation framework or outsource the EU institutions for that matter. A couple of important things to keep in mind:

- » For securitisations which the originators are from outside the EU, investors' due diligence will have extended requirements.
- » For the purpose of STS, it is mandatory that originators, sponsors and Securitisation Special Purposes Entities (SSPE) are located in the EU.

## STS criteria discussion

### Simple

The criteria categorised as simple relate to the underlying exposures and how these exposures are selected.

### No re-securitisation

Underlying exposures shall not include any securitisation positions. In other words, securitisation deals backed by other securitisation deals shall not be classified as STS.

## Homogeneity

Underlying exposures shall be homogeneous in terms of asset type and their contractual, credit-risk and prepayment characteristics. The main goal here is to enable investors to assess the risk of the pool of underlying exposures using common methodologies and parameters. Based on that, regulation establishes four conditions for underlying exposures to be considered homogeneous:

- » They have similar underwriting standards.
- » They have similar servicing procedures.
- » They fall within the same asset category. Please refer to the eligible asset categories listed above.
- » Given the wide scope of asset categories, for the underlying exposures within the same asset category, they need to comply with at least one homogeneity factor. Exceptions are trade receivables and credit facilities to individuals, which are already considered sufficiently homogeneous and where the application of the homogeneity factors would cause excessive concentrations in the pool. The homogeneity factors include type of obligor, ranking of security on a property (1<sup>st</sup>, 2<sup>nd</sup>...liens), type of immovable property and jurisdiction of the property/obligor. Below is a mapping of the homogeneity factors available for each category extracted from the draft RTS:

HOMOGENEITY FACTOR/ASSET CATEGORY	TYPE OF OBLIGOR	RANKING OF SECURITY ON COLLATERAL	TYPE OF IMMOVABLE PROPERTY	JURISDICTION OF PROPERTY/OBLIGOR
Residential loans	X	✓	✓	✓
Commercial loans secured with mortgages	X	✓	✓	✓
Credit facilities to individuals for personal, family or household consumption purposes	X	X	X	X
Credit facilities to enterprises (incl. SMEs) and corporates	✓	X	X	✓
Auto loans and leases	✓	X	X	✓
Credit card receivables	✓	X	X	✓
Trade receivables	X	X	X	X
Underlying exposures that all do not fall under the asset categories listed	✓	✓	✓	✓

## Payment periodicity

Underlying exposures shall have defined periodic payment streams.

## No transferability

Underlying exposures shall not include transferable securities other than corporate bonds not listed on a trading venue. Transferable securities mean those classes of securities which are negotiable on the capital markets.

## Default

Underlying exposures shall not include, at the time of their selection, defaulted or credit impaired debtors or guarantors who:

- » Have been declared insolvent or undergone debt-restructuring processes within three years prior to the date of the transfer.
- » Were insolvent and/or with public registered adverse credit history or
- » Have a credit risk assessment significantly higher than the comparable non-securitised exposures held by the originator.

## Seasoning

Underlying borrowers shall, at the time of the transfer, have made at least one payment, except if exposure is payable in a single installment.

## No dependency

The repayment of the securitisation shall not depend on the sale of assets backing the underlying exposures when these assets are guaranteed by a repurchase obligation.

## True sale

Underlying exposures shall leave the originators' balance sheet.

### **Representations and warranties**

The originator shall provide representations and warranties that underlying exposures are not encumbered or in a condition that would adversely affect their true sale. The selected pool shall not have dual-encumbered underlying exposures or self-certified mortgages, where information provided by the loan applicant might not have been verified by the lender.

### **Eligibility**

The selection of the underlying exposures shall be random, based on the eligibility criteria defined in the transaction documents, and, therefore, shall have similar characteristics to the ones left on the originator balance sheet (no "cherry-picking"). The payments of STS securitisations should depend exclusively on the performance of the underlying exposures and any inclusion of additional underlying exposures after the closing should meet the eligibility criteria set in the deal documentation, following the same mechanism used to structure the initial pool.

### **Underwriting**

The originator shall have an established performance history for similar receivables to those being securitised and for an appropriately long period of time.

### **Transparent**

The transparent criteria is associated with the information disclosed to investors so as to ensure that they can do a proper due diligence, either before a purchase or on an ongoing basis.

### **Historical data**

The originator shall provide data on static and dynamic historical default and loss performance for substantially similar exposures to those being securitised to potential investors before pricing. Data shall cover a period of at least five years.

### **Sample verification**

A sample of the underlying exposures data shall be verified by a third party prior to issuance of the securities. That external independent party has to confirm that the data disclosed is accurate, but the originator is still the responsible and has to respond for the compliance of the data.

### **Cash flow model**

The originator shall provide a liability cash flow model to potential investors before the pricing and on an ongoing basis. The goal is to assist investors in their ability to appropriately model the cash flow waterfall. Models should be available at securitisation repositories.

### **Environmental performance**

For auto loans or leases and residential mortgage only, the originator shall publish any available information related to the environmental performance of the assets backing the underlying exposures. RMBS, for example, shall report the Energy Performance Certificate (EPC) of the underlying assets as this will become more relevant for future restrictions/requirements and also given the development of the green bond sector.

### **Standardized**

Standardized relates to standard structural components that will ensure deals can be easily compared.

### **Risk retention**

The originator shall satisfy the risk-retention requirement and hold a net interest of 5%. Regulators are now taking a more direct approach towards this topic, making originators the responsible for the retention of the material net economic interest, whereas before the burden was on the investors that were only permitted to buy securitisations if the risk retention requirements were met.

### **Risk mitigation**

Derivative contracts can only be used for hedging interest-rate and/or currency risk.

### **Interest payments**

Interest payments have to be referenced and rely on commonly used market indexes. Complex formulas or derivatives must be avoided.

### **Acceleration notice**

Transactions shall have standard rules in case an enforcement or acceleration notice is delivered, that means:

- » No cash shall be trapped in the SSPE beyond what is necessary to ensure its operational functioning or the orderly repayment of investors, unless exceptional circumstances require payment of certain expenses in order to avoid the deterioration in the credit quality of the underlying exposures.
- » Principal available funds shall be passed to investors via sequential amortisation, as determined by the seniority of the tranches.
- » Repayment of the securitisation positions shall not be reversed with regard to their seniority.
- » No provisions shall require automatic liquidation of the underlying exposures at market value.

### **Sequence of payments**

Transactions with non-sequential priority of payments shall have performance triggers on the underlying exposures. If triggers are reached, priority of payments reverts into sequential payments according to the tranches seniority. Such performance-related triggers shall include at least the deterioration in the credit quality of the underlying exposures below a predetermined threshold.

### **Triggers**

Transactions shall have early amortisation triggers defined in the deal documents in case:

- » The underlying exposures present a deterioration in their credit quality below a predetermined threshold.
- » There is an insolvency-related event related to the originator or the servicer.
- » The value of the transaction underlying exposures falls below a predetermined threshold (early amortisation event).
- » There aren't sufficient new underlying exposures that meet a predetermined credit quality to add to the transaction during the revolving period.

### **Documentation**

Transaction documentation shall define:

- » Duties and contractual obligations for the Servicer and Trustee.
- » Processes to ensure that a default of the Servicer doesn't affect the servicing.
- » Replacement provisions of other counterparties.

### **Servicer**

The servicer shall have expertise in servicing exposures of a similar nature to those securitised and shall have well-documented and adequate policies, procedures and risk-management controls relating to the servicing of exposures.

### **Remedies to defaults**

Transaction documentation shall contain definition, remedies and actions on delinquency and default of debtors, debt restructuring, debt forgiveness, forbearance, payment holidays, losses, charge offs, recoveries and other asset performance indicators. It shall clearly specify priorities of payment and events which trigger changes in such priorities as well as the obligation to report such events.

### **Resolution of conflicts**

Transaction documentation shall include clear provisions to the timely resolution of conflicts between different classes of investors and the allocation of voting rights between them.

## Conclusion

While a new regulatory framework was much needed, there remains some level of confusion in the market in and around a number of areas, including:

- » What asset classes are eligible for STS?
- » Which of the prescribed rules relate to STS classification and which are a general requirement for all securitisation transactions?
- » What tools do organisations need to best attain the STS designation?
- » What organisational procedures must be modified to support the STS designation?

In this paper, we have tried to answer to some of these questions. Furthermore, Moody's Analytics and our team of securitisation experts look forward to the opportunity to work with our clients to support to help support some of the most pressing operational and system requirements introduced through the new securitisation regulation and STS.

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