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WORKING PAPER

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MEETING DOCUMENT

From:	Commission
To:	Working Party on Financial Services (Securitisation)
Subject:	Commission services non-papers on eligible parties to EU securitisations and drafting proposals for the homogeneity articles

As agreed in the political trilogue on 7 February, the Commission prepared a non-paper on eligible parties to EU securitisations, including some drafting proposals, as well as drafting proposals for the homogeneity articles. Both are attached. Please note that for reasons of readability, Commission has stated what text was used as basis for the drafting proposal (i.e. ECON or Council) and any added language is bold and underlined, while deleted language is bold and stroke-through.

These proposals will not be discussed in tomorrow's political trilogue. The Presidency would like to hear your views on them in the working party meeting that will take place later this month to prepare the 4th political trilogue on 29 March.

COMMISSION SERVICES NON-PAPER

ELIGIBLE PARTIES TO SECURITISATION

3 MARCH 2017

1. Introduction and rationale for the drafting proposal

Three main financial stability risks have to be addressed to revive a safe securitisation market: poor credit quality of underlying assets, the creation of a credit bubble in the case of rapid growth of securitised assets and interconnectedness of banks and non-banks.

The set of micro- and macro-prudential measures introduced in the EU since the crisis, coupled with the additional provisions in the proposal on Simple, Transparent and Standardised securitisations (STS proposal), **tackle effectively the three risks** highlighted above. These measures are:

- Risk retention requirements
- Capital requirements for banks sponsoring securitisation programmes;
- Increased capital requirements for investments in securitisations;
- Liquidity requirements (Liquidity Coverage Ratio and Net Stable Funding Ratio);
- Maximum risk weights (1250%) and no STS eligibility for re-securitisation;
- Strict controls on maturity transformation;
- High standards for mortgage underwriting standards (Mortgage Credit Directive).

Thanks to these measures, any issuer of securitisation must have at least 5% of capital paid in and any credit, liquidity and maturity risks it is exposed to for sponsoring or investing in securitisations are accounted for by LCR, the upcoming NSFR and higher risk weights. Sponsored securitisation vehicles cannot be excluded from the sponsor bank's balance sheet so that all risks generated by these vehicles are accounted for in capital and liquidity requirements. In conclusion, highly leveraged, financially weak investors in securitisation such as structured investment vehicles¹ (SIVs) prevalent in the US before the crisis cannot exist under the current EU regulatory framework. **EU investors in securitisation are covered by a microprudential framework that has incorporated the lessons of the crisis and the global standards developed in the Basel Committee, the FSB and IOSCO.**

In addition there is the whole **set of macroprudential tools that were not there before the crisis**. Among them:

- Adjustable risk weights for securitisations;
- Additional capital buffers for selected exposures (such as securitisation);

¹ Common in the US before the crisis while almost non-existent in Europe, SIVs typically invested in medium-term securitisations of US subprime mortgages and funded these investments issuing short term securitisations. Hence they were re-securitisations. They needed little paid-in capital since they were not required to retain any risk of the underlying pool of assets. Banks investing in them had to maintain small capital requirements. Banks sponsoring them did not have to account for them in their balance sheets, hence they faced no capital requirements for sponsoring the SIV. Since there were no liquidity requirements, the liquidity risks taken by banks in sponsoring the SIV were also unaccounted for. Finally, mortgage lending was less strictly regulated and US public agencies (e.g. Fannie Mae and Freddie Mac) put a governmental guarantee on the mortgages underlying most of the securitisation bought by SIVs. None of these features are replicable in the EU securitisation regulatory framework.

- Borrowers' based measures (e.g. Loan-to-Value, Debt-to-Income limits);
- Additional capital buffers for systemic institutions involved in securitisation.

These have been identified as effective tools to tackle market overheating and excessive interconnectedness, as well as to prevent asset bubbles from developing. A growing literature on the issue shows that these tools have been effective in tackling such risks in the past². Should EU or non-EU investors fuel excessive credit growth via securitisation, the ESRB has the mandate to identify the risk and recommend to the Commission, the ESAs and Member States the use of the above mentioned tools to tackle it.

The set of micro- and macro-prudential reforms introduced since the crisis ensures a stable, tightly regulated investor base for EU securitisation markets. The proposal to restrict the ability to invest in EU securitisation to entities that are under EU or 3rd country equivalent financial regulation is thus largely unnecessary and problematic.

It is unnecessary because the risks of the creation of a credit bubble and poor credit quality are already catered for by the micro- and macroprudential tools highlighted above. It is problematic because, by limiting considerably the investor base, the proposal would increase interconnectedness and concentration of risk among fewer eligible investors. While it would still need to be assessed which 3rd country investors would be deemed eligible to buy EU securitisations under the EP proposal, it is likely that only EU investors and, perhaps, a handful of non-EU investors would be eligible, thereby concentrating all the risks on their balance sheets. The limitation is also likely to reduce the diversity of investor strategies and preferred risk-reward profiles, thereby reducing liquidity and causing higher volatility in securitisation markets.

As for the limitations on issuers, the Commission proposal already requires the originator and the sponsor to be under EU supervision. It explicitly requires Member States to appoint a supervisor that will supervise any non-regulated entities issuing securitisations. The ECON text would prevent all non-financial entities from issuing securitisation without support of a financially regulated entity. Several non-financial corporations currently issue securitisation to fund their activities without financial intermediaries, and there are no clear reasons to prevent that.

In order to ensure a well-regulated and stable investors and issuers base for EU securitisations, the co-legislators should therefore:

- Remove the limitations on investors and issuers presented in Article 2a, while introducing a suitability test and, in case an investor does not pass the test, a ban on retail investors (**see section 2**)
- Extend the CRR underwriting standards thus ensuring that both regulated and non-regulated issuers are subject to strict EU supervision on credit underwriting standards (**see section 3**).
- Strengthen the regulation and supervisions of sponsors (**see section 4**).

² See: "IMF-FSB-BIS elements of effective macroprudential policies – lessons from international experience", August 2016

2. Drafting proposal on eligible parties

The limitations included in article 2a of the ECON text could be removed and replaced with limitations on retail investment, since all parties in the trilogue agreed that securitisations are complex instruments, not suitable for all retail investors. To do so, the existing legislation in MIFID can be used as a basis, since it requires suitability tests to be performed before financial instruments can be sold to investors. We further suggest to strengthen the existing requirements in MiFID in the STS proposal.

In MIFID, investment firms must conduct a suitability test with an investor before selling an instrument. If the instrument is deemed unsuitable for the investor, the seller must warn the investor about the risks. However, under MiFID, if the investor disregards this warning he/she can still buy the instrument deemed unsuitable. In the case of STS, this framework can be strengthened by banning any sale to non-professional/retail investors if the securitisation is deemed unsuitable. Importantly, if the seller concludes that the securitisation is suitable for the investor and thus decides to sell it to the investor (for example, because this is a high net worth individual or a family office), it must put in writing the assessment of suitability, thereby exposing itself to legal liability.

This approach is preferable to an outright ban to sell to retail investors for various reasons:

1. it effectively excludes non-sophisticated retail investors since, in practice, the complexity of securitisations is rarely appropriate for non-sophisticated investors, and the seller will be exposed to litigation in case the assessment is not solid;
2. an outright ban would exclude sophisticated investors such as high net worth individuals and family offices

It is also worth recalling that from next year, MIFID II will give national competent authorities the right to ban any instrument they deem inappropriate for retail investors.

One possible drafting suggestion could be as follows:

Drafting suggestion Art 2a (lines 89 - 95) - (based on the ECON compromise text)

Article 2a

Parties to the securitisation market

1. The seller of a securitisation position shall not sell such securitisation position to a retail client, as defined in Article 4(1) of Directive 2014/65/EU, unless all of the following conditions are fulfilled:

- a) **the seller of the securitisation position has performed a suitability test in accordance with Article 25(2) of Directive 2014/65/EU;**
- b) **the seller of the securitisation position is satisfied, on the basis of the test referred to in point (a), that the securitisation position is suitable for that retail client;**
- c) **the seller of the securitisation position immediately communicates to the retail client the outcome of the suitability test in a report.**

~~Investors in securitisation shall be institutional investors other than the originator, sponsor or original lender of a securitisation, or institutions of third~~

~~countries and territories whose supervisory and regulatory requirements are considered equivalent to the requirements of the Union under the acts referred to in the Article 2(12)(i) to 2(12)(ix), as applicable.~~

~~2. In a securitisation, at least one of the originator, sponsor or original lender shall be a regulated entity as defined in Article 2(4) of Directive 2002/87/EC, as amended, Article 4(2) of Directive 2014/17/EU, a financial institution whose main corporate objective is to provide financial accommodations, such as loans, leases, hire-purchase arrangements or similar accommodations falling within the scope of Article 4 paragraph 1 sub 26 of Regulation (EU) No 575/2013 that conducts the lending business or financial leasing pursuant to point 2 and 3 of Annex I to Directive 2013/36/, or a multilateral development bank within the meaning of Article 117(2) of Regulation (EU) No 575/2013.~~

In addition, as discussed in the trilogue on 7 February, a reference to ESRB's macroprudential tools could be introduced. This should be discussed further in the trilogues together with the rest of the section on macroprudential supervision.

3. Drafting proposal on credit underwriting standards

The reforms enacted after the crisis have set the credit underwriting standards at a high level, but **in order to further assuage any fear that a revival in the securitisation market could lead to a decline in such standards it could be considered to introduce the Council amendments extending these standards beyond the banking sector.** The proposed article effectively applies the same strict underwriting standards envisaged in CRR to any originator of loans/assets that are then packaged in a securitisation. The Council text could also be strengthened by introducing a specific criterion for residential mortgages (the biggest part of EU securitisation markets). This (paragraph 1a) is taken from the STS criterion 8.6 and extended to non-STS securitisations as well. One possible drafting suggestion could be as follows:

Drafting suggestion Art 5a (lines 374 - 377) - *(based on the Council general approach)*

Article 5a Criteria for credit-granting

1. Originators, sponsors and original lenders shall apply to exposures to be securitised the same sound and well-defined criteria for credit-granting which they apply to non-securitised exposures. To this end the same clearly established processes for approving and, where relevant, amending, renewing and re-financing credits shall be applied. Originators, sponsors and original lenders shall have effective systems in place to apply those criteria and processes in order to ensure that credit-granting is based on a thorough assessment of the obligor's creditworthiness taking appropriate account of factors relevant to verifying the prospect of the obligor to meet his obligations under the credit agreement.

1a. Where the underlying exposures of securitisations are residential loans, the pool of those loans shall not include any loan that is marketed and underwritten on the premise that the loan applicant or, where applicable, intermediaries were made aware that the information provided might not be verified by the lender.

2. Where an originator purchases a third party's exposures for its own account and then securitises them, that originator shall verify that the entity which was, directly or indirectly, involved in the original agreement which created the obligations or potential obligations to be securitised fulfils the requirements in accordance with the first paragraph.

4. Drafting proposal on sponsor supervision

The introduction of an article on sponsors' regulation could provide further reassurance that any risk (in particular liquidity risk) taken by banks sponsoring securitisations will be accounted for and thus could not fuel the resurgence of highly-leveraged investors and asset bubbles. In this light, it could be envisaged to maintain the Parliament's requirement for regular liquidity stress tests, with the following drafting specifying that a bank that has passed the annual stress test does not need to repeat it to be eligible for sponsoring an ABCP programme. One possible drafting suggestion could be as follows:

Drafting suggestion Art 12a.3 (line 485) - (based on the ECON compromise text)

Article 12a

Role of the sponsor of an ABCP programme

3. Before being able to sponsor a STS ABCP programme, the credit institution shall demonstrate to its competent authority that its role under paragraph 2 does not endanger its **solvency and liquidity**.

The requirement referred to in the first subparagraph shall be considered to be fulfilled where the competent authority has determined, on the basis of the review and evaluation referred to Article 97(3) of Directive (EU) No 36/2013, that the arrangements, strategies, processes and mechanisms implemented by that credit institution and the own funds and liquidity held by it ensure a sound management and coverage of its risks.

~~financial stability, not even in an extreme stress situation in the market, where short term funding market dries up for all the ABCP programmes for which it has that role. For that purpose, the sponsor shall on a regular basis provide its supervisor with specific information concerning its cumulative liquidity risk obligations and how those obligations can be borne by its liquidity buffers.~~

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HOMOGENEITY ARTICLES

3 MARCH 2017

Notice that the list of asset types examples (pools of residential loans, pools of corporate loans etc.) has been deleted because the EBA guidelines would provide clarity on asset types categorisation and it is preferable to avoid examples in legal provisions in order not to suggest the list of examples is exhaustive.

Drafting suggestion art 8.4 (line 403)

(based on the Council general approach)

4. The securitisation shall be backed by a pool of underlying exposures that are homogeneous in terms of asset type., ~~such as pools of residential loans, pools of corporate loans, leases and credit facilities to undertakings of the same category to finance capital expenditures or business operations, pools of auto loans and leases to borrowers or lessees and pools of credit facilities to individuals for personal, family or household consumption purposes. A pool of underlying exposures shall only comprise one asset type.~~ The underlying exposures shall be contractually legal, valid, binding and enforceable obligations with full recourse to debtors and, where applicable, guarantors. The underlying exposures shall have defined periodic payment streams, the instalments of which may differ in their amounts, relating to rental, principal, interest payments, or related to any other right to receive income from assets supporting such payments. The underlying exposures shall not include transferable securities, as defined in Article 4(1), point 44 of Directive 2014/65/EU of the European Parliament and of the Council other than corporate bonds, provided that they are not listed on a trading venue.

- [9a. With a view to establishing consistent, efficient and effective supervisory practices within the single market and to ensuring the common, uniform and consistent application of Union law, the European Banking Authority (EBA), in close cooperation with the European Securities and Market Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA), may issue guidelines to further specify the characteristics on the basis of which the underlying exposures referred to in paragraph 4 are deemed to be homogeneous in terms of asset type, including the characteristics relating to the cash flows of different asset types taking into account their contractual, credit risk and prepayment characteristics.]

Drafting suggestion art 12.2 (line 467)

(based on the Council general approach)

2. Transactions within an ABCP programme shall be backed by a pool of underlying exposures that are homogeneous in terms of asset type., ~~such as pools of trade receivables, pools of corporate loans, leases and credit facilities to undertakings of the same category to finance capital expenditures or business operations, pools of auto loans and leases to borrowers or lessees or loans and pools of credit facilities to individuals for personal, family or household consumption purposes. A pool of underlying exposures shall only comprise one asset type.~~ The pool of underlying exposures shall have a remaining weighted average life of not more than one year and none of the underlying exposures shall have a residual maturity of longer than three years, except for pools of auto loans, auto leases and equipment lease transactions which shall have a remaining exposure weighted average life of not more than three and a half years and none of the underlying exposures shall have a residual maturity of longer than six years. The underlying exposures shall not include loans secured by residential or commercial mortgages or fully guaranteed residential loans, as referred to in point (e) of Article 129(1) of Regulation (EU) No 575/2013. The underlying exposures shall contain contractually binding and enforceable obligations with full recourse to debtors with defined payment streams relating to rental, principal, interest, or related to any other right to receive income from assets warranting such payments. The underlying exposures shall not include transferable securities, as defined in Article 4(1), point 44 of Directive 2014/65/EU other than corporate bonds, provided that they are not listed on a trading venue.

- [8. With a view to establishing consistent, efficient and effective supervisory practices within the single market and to ensuring the common, uniform and consistent application of Union law, the European Banking Authority (EBA), in close cooperation with the European Securities and Market Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA), may issue guidelines to further specify the characteristics on the basis of which the underlying exposures referred to in paragraph 4 are deemed to be homogeneous in terms of asset type, including the characteristics relating to the cash flows of different asset types taking into account their contractual, credit risk and prepayment characteristics.]