

## Position Paper

February 2017

### Towards a new European Securitisation Framework

### AFME technical comments on “grandfathering” under the STS regulation

#### Introduction

Legislation changes over time. “Grandfathering” is an informal term which refers to the need, in new legislation, to recognise transactions undertaken in compliance with previous versions of the legislation. It is necessary because market participants will have complied with legislation as it existed at the time transactions were entered into, but which cannot easily be changed (if at all) retrospectively to comply with new requirements.

Failure to recognise pre-existing transactions entered into in good faith in compliance with legislation as it existed at the time would be unfair to transaction counterparties and also risk creating serious market disruption by causing fire sales by investors of previously sound transactions which had suddenly become non-compliant in some way, and thereby subject to capital or liquidity penalties. Appendix 1 sets out our estimates, based on Nomura data, that some €130 billion of existing European securitisations could be at risk if appropriate grandfathering is not achieved.

On the other hand, the policy initiative behind new legislation – for example to raise market standards – should be recognised. Prudential concerns should be considered. Market participants should be encouraged to comply with new requirements, so long as it is reasonable and practical for them to do so.

A balance therefore needs to be struck between on the one hand the reasonable and legitimate recognition of previous transactions entered into in good faith and avoidance of market disruption, and on the other the preservation of prudential standards and effective implementation of new policy objectives. These two aims are not mutually exclusive; indeed, sensible grandfathering preserves a body of existing transactions which can and should provide a launching pad to support issuance and future trading of new and improved structures and transactions.

#### Grandfathering in the context of STS

The issue of grandfathering arises whenever new legislation in any field is contemplated, but in the context of the new securitisation framework it is a particularly complex and intricate issue that requires precise drafting in the relevant regulation.

This is because there is a complex interplay between:

- different “vintages” of existing transactions which have already complied with different versions (since 2011) of previous European securitisation legislation in this area; and

- different implications for treatment, and practicality of compliance, for different aspects of securitisation: for example, risk retention, transparency and due diligence, as well as the appropriate application of all the detailed STS criteria.

This position paper summarises the principles which must be applied in order for grandfathering to operate in an appropriate manner under the new framework. To assist with framing the issues and relevant vintages, in this paper we refer:

- the treatment under the STS Regulation of transactions issued before 1<sup>st</sup> January 2011 (the implementation of the first version of the risk retention rules). Many of these transactions already benefit from “grandfathering” under the current risk retention legislation<sup>1</sup>. This relief was provided by the EU authorities at the time in acknowledgement of the significant issues which would arise if the risk retention requirements were applied on a retrospective basis.
- “Pre-STS Transactions” - by which we mean any transaction established before the effective date of the new STS Regulation, regardless of whether this was before or after 1<sup>st</sup> January 2011.

### **Risk retention and transparency**

For both of these, three general principles apply:

1. Only one set of rules should apply to any given transaction over the course of its life.
2. The full detail of those rules must be known before the rules begin to apply, with sufficient lead time to permit appropriate preparatory work for compliance.
3. To avoid cliff effects, the date of establishment of an arrangement should be used to determine grandfathering, rather than the date of issuance of any particular liabilities under that arrangement.

Further detail on these principles is set out below.

For risk retention, the rules in place at the time the relevant transactions were established should continue to apply for the life of the transaction, regardless of the date(s) of issue of any liabilities under the relevant transaction. Focus on the date of establishment of the relevant structure (rather than on issuance) is consistent with the approach adopted in the current risk retention requirements and is essential for repeat issuance structures (such as ABCP conduits and master trusts) given that it would be extremely difficult (if not impossible) in practice in the context of many existing transactions to revise the retention arrangements during the life of the transaction.

In keeping with this general principle the most sensible approach is to extend the relief that was included in the CRD II text in relation to pre-2011 transactions, and to establish equivalent relief for transactions established under either Article 122a or Article 404-410 of the CRR. Under this approach, existing transactions will remain subject to the retention rules in place when the transactions were first established or, in the case of Pre-2011 Transactions, benefit from relief with a longstop date triggered by the addition of new underlying assets to the transaction.

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<sup>1</sup> Although transactions that have added new assets on or after 1st January 2014 are required to comply.

As an additional matter, in order for the risk retention rules to function sensibly for transactions established on or after the application date of the recast obligations, it is also necessary to ensure that only one set of corresponding regulatory technical standards applies in respect of such transaction for its life. In the absence of this, compliance uncertainty may arise in respect of transactions as the corresponding regulatory technical standards provide essential guidance on the interpretation of the risk retention requirements.

For transparency, the same principles as described above should be applied in general. Moreover, because the corresponding reporting templates to be made by technical standards must be in place for market participants to comply, no action should be required under the transparency requirements until such standards are finalised. In the context of the STS criteria and the cross-referenced transparency requirements, we suggest that a principles-based set of disclosure rules should apply for pre-STs transactions. The rules currently existing in Art. 409 of the CRR would be a good model.

### **Due diligence**

For due diligence, once again, the same principles as described above should be applied in general. As a bottom line, investors should only have to check that transactions comply with diligence rules that are *applicable to those transactions* when established rather than the most recent rules. This is essential given that under the proposed due diligence obligations, institutional investors would be required to verify that the *newest* risk retention and transparency standards are complied with, notwithstanding the (limited) transitional relief provided at Article 28.

### **STS criteria**

There are a number of the proposed STS criteria that are either irrelevant for legacy transactions or whose relevance and importance diminish very quickly following issuance. It therefore makes sense to exempt existing transactions from having to comply with these criteria while nonetheless permitting them to qualify as STS.

There is a further category of criteria where the failure to meet the criteria may simply be a case of the relevant disclosure not having been made, or design feature not being included at the time the transaction was marketed, because the disclosure or feature was not deemed relevant or material prior to the STS criteria being in place. The sensible solution here would be to permit such criteria to be complied with where the originator, sponsor and/or issuer make the relevant disclosure or include the relevant feature as part of (or along with) their STS notification contemplated at Article 14.

The Solvency II Delegated Act (see Article 177(4)) takes a broadly similar approach in that it exempts legacy transactions from all Type 1 criteria save:

- the credit quality requirement (irrelevant for STS, given the move away from credit quality as a focus);
- the requirement that the securitisation position be the senior tranche of its transaction (irrelevant for STS, given the move away from credit quality as a focus);
- the "true sale requirement;
- the pool homogeneity requirement;
- the prohibition on resecuritisations; and

- the prohibition on derivatives or other transferable financial instruments in the pool.

Our suggestion is less permissive (i.e. tougher) than Solvency II. Our proposals in respect of each of the STS criteria (by Article number as it appears in the Commission proposal) in respect of legacy transactions appear in Appendix 2. For simplicity this note simply addresses the broad approach to each of the criteria that we think would be sensible for legacy transactions.

8(1): Require compliance.

8(2): Representations and warranties. We would suggest exempting legacy transactions. These representations and warranties are not currently market standard, and few if any legacy transactions would comply. Further it would be very difficult to comply retrospectively with these representations and warranties and the credit quality of the portfolio is likely to have been already established by the credit history of the securitised portfolio in any case.

8(3): Require compliance. Where documentation allows active management of the portfolio, transactions should be allowed to comply where (1) the originator, sponsor and/or (2) issuer disclose in their STS notification that no further active management will be undertaken and an undertaking is given by them to this effect as well.

8(4): Require compliance.

8(5): Require compliance.

8(6): Require compliance, provided that material changes to underwriting standards need only be disclosed on a prospective basis from the date of the STS notification.

8(7): Underlying exposures not in default. Exempt legacy transactions. The relevance of this criterion drops off very quickly following issuance, as investors are likely to use the credit history of the securitisation/securitised portfolio to make investment decisions following issuance, not initial transaction data which is by then of historic interest only. Even transactions that are initially STS could over time, gather exposures in default and to credit impaired obligors over the life of the deal. While we acknowledge this type of distinction may be useful at issuance with a new portfolio, its relevance is very limited for existing deals that have been outstanding for more than a few months.

8(8): Debtors made at least one payment. Exempt legacy transactions. The requirement to have made at least one payment is primarily an anti-fraud measure. Once a single transaction has been made (even if that is after the transfer of the exposure to the portfolio) the function of the criterion has been fulfilled.

8(9): Require compliance.

9(1): Risk retention. Exempt legacy transactions subject to the transaction complying with the risk retention requirements which are anyway applicable to it under the relevant transitional provisions (discussed above).

9(2): Require compliance, provided that the disclosure of interest rate and currency risk mitigation measures may be made (or completed) in the STS notification.

9(3): Require compliance.

9(4-8): These provisions are difficult cases. They all fall into the category of structural or documentation features for which there is a sensible case to be made and we are generally supportive of their inclusion in the STS framework. They are nonetheless all provisions that legacy transactions are likely to struggle to comply with for technical reasons. We would submit that they all represent cases where the benefit to the market of exempting legacy transactions from complying outweighs the additional risk that would be permitted as a result. This is especially true in respect of 9(6) and 9(7) because the very fact that the transaction has been running for some time will have clarified some of the items on which those criteria seek to shed light in the documentation. For these reasons we would suggest exempting legacy transactions, but we acknowledge that this is more a policy judgment related to weighing up the relative benefits and risks to the market.

10(1): Historic default data. Exempt legacy transactions on the basis that the securitisation itself will have a credit history already and subject to the transaction complying with a principles-based set of disclosure requirements modelled on Art. 409 of the CRR.

10(2): Pool audit. Exempt on the basis that this is a requirement relating to the initial offering document for the transaction which cannot sensibly be complied with retrospectively.

10(3): Require compliance, provided that the liability cash flow model need only be provided on a prospective basis from the date of the STS notification.

10(4): Disclosure prior to pricing. Exempt legacy transactions subject to the transaction complying with a principles-based set of disclosure requirements modelled on Art. 409 of the CRR.

## Conclusion

AFME has already sought to address the complex technical drafting issues arising out of the need to grandfather existing transactions in the suggested amendments we have already tabled and which are set out in Annex 1 hereto. AFME is fully committed to a successful new securitisation framework (including an STS framework that is adopted as widely as possible), and the purpose of our amendments is to achieve that; not to avoid or diminish compliance with the new regime for new transactions.

For the new recast risk retention, transparency and due diligence requirements to function sensibly, they need to apply in respect of newly established transactions only. In the context of Pre-STS Transactions, it needs to be made clear that the rules in place at the time the relevant transactions was established will continue to apply for the life of the transaction, regardless of the date(s) of issue of any liabilities under the relevant transaction. In the context of the STS regime, to ensure that the regime will work, and to allow for a recovery in European securitisation, particularly bearing in mind the likely result of future amendments to the LCR, Solvency II and bank capital treatment as well as other follow-on legislation, it is critical that Pre-STS Transactions are in practice able to benefit from STS treatment ***when they meet certain core simplicity, transparency and standardisation criteria***, such as true

sale, encumbrance, homogeneity, credit impairment, waterfall rules, as well as other criteria which can be reasonably met today (e.g. no active pool management).

We also note that the Solvency II delegated rules on "Type 1 securitisations" (in Article 177 paragraph 4 of Commission Delegated Regulation (EU) 2015/35) similarly apply a limited set of criteria to existing transactions.

In particular, in the context of STS, we would recommend that, while this approach is complex, the grandfathering rules recognize the importance and quality of existing transactions by:

- ensuring that cross-references to compliance with risk retention requirements are properly adjusted to refer to the requirements applicable to the relevant arrangement based on its date of establishment and the rules in effect at that time;
- providing a limited set of criteria for Pre-STS Transactions; and
- not seeking to apply any revised standards to existing arrangements in general.

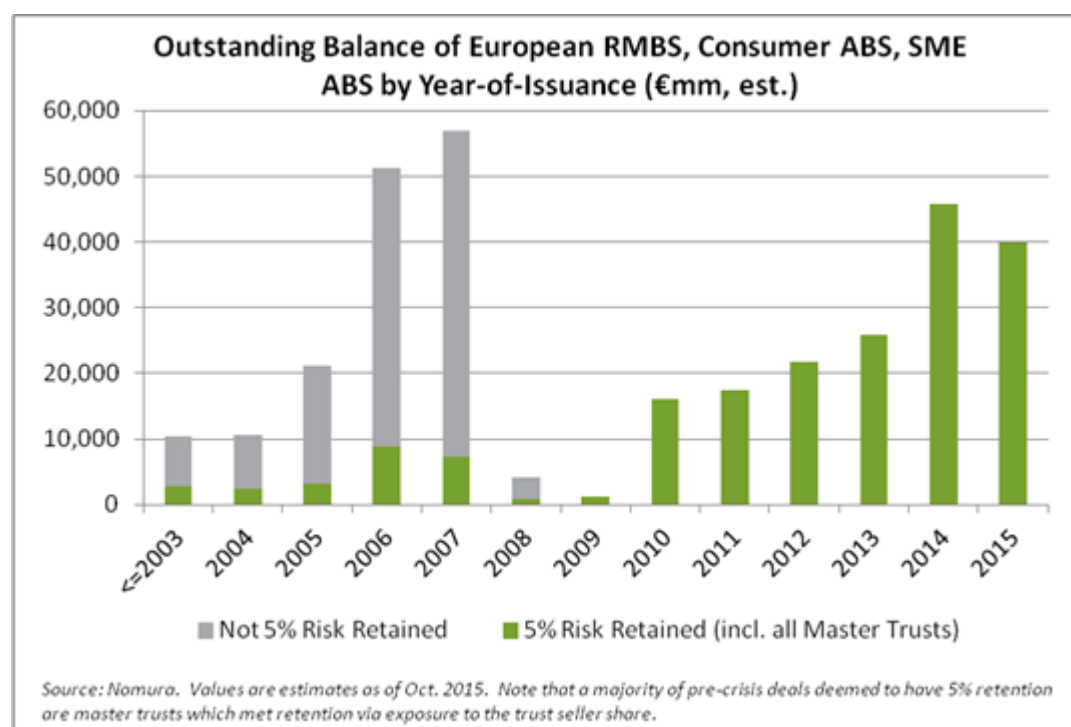
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## **Appendix 1**

We estimate, based on Nomura data, that there is currently about €130bn in legacy transactions backed by residential mortgage, consumer and SME loans and held by investors that are likely not to meet the 2011 risk-retention rules. Our data analysis focuses on these three sectors because the data is more difficult to estimate for other asset classes and some other large segments such as CMBS and CLOs will likely not meet certain other STS criteria anyway.

To put the figures in context, €130bn amounts to about 40% of all European RMBS/Consumer/SME ABS outstanding as of today (€320bn), and almost 25% of the entire European ABS market (all sectors) based on the Nomura database (€540bn).



It is important also to note that:

- the data reflects legacy transactions which likely did not meet any of the following at issuance: the 5% “vertical slice” or seller share retention, the 5% first-loss securitisation tranche retention, or the 5% first loss on the underlying loans themselves (as introduced in 2014); all master trusts are assumed to have met the retention requirement, normally either via the seller share or the later retention of a 5% first loss tranche introduced via restructuring to meet the (then) new retention rules as they were introduced (note these make up a majority of pre-crisis deals likely to have met the requirement);
- the data does not reflect potential retention compliance with the 5% random selection of loans option, as we are unable to verify if these were met at the time of issuance and since that time. It is possible that much of the €130bn of issuance was issued by banks which might have met the requirement (at least in spirit) without documenting it at the time (as of course there was no requirement for them to do so), although checking this would be a very costly and administratively burdensome exercise; and

- just because these legacy transactions do not meet the 2011 risk-retention guidelines does not mean that the sponsor/originator did not retain risk. We believe a sizeable majority of these deals did have first-loss retention, although it often did not meet the level of 5% at issuance. It is possible that some of these transactions would meet the 5% requirement today as a result of deals de-leveraging over time (as senior tranches have paid down).