LCR and Securitisation – 2B or not 2B

The European Commission has now published the final draft of the Commission Delegated Regulation with regard to liquidity coverage requirement (the "**LCR Delegated Act**"), likely to apply to EU banks from late 2015. Once approved, the LCR Delegated Act will, for the first time, create a detailed framework for a liquidity buffer required to cover their net liquidity outflows over a 30 calendar day stress period. The eligibility of a wide range of securitisation products is good news for the industry in principle. In this briefing, we explain the types of securitisation assets that will be eligible and explore the possible consequences for the securitisation markets.

Although they will only be eligible for inclusion at Level 2B – the lowest level – the recognition of certain securitisations as "high quality liquid assets" ("HQLA") for the purposes of the LCR liquidity buffer is a key development for the European securitisation market because it will increase the attractiveness of securitisations for European bank investors.

Designation of securitisations as Level 2B assets means they can make up no more than15% of the overall liquidity buffer. They will also be subject to minimum haircuts of 25% (for RMBS and auto receivables ABS) or 35% (for consumer and SME ABS). Nonetheless, the LCR Delegated Act provides for a much greater variety of eligible assets than both the Basel LCR standard published in January 2014 and the early drafts of the LCR Delegated Act. AAA RMBS have been mooted as a possible Level 2B asset for some time, but certain ABS backed by auto loans and auto leases, consumer loans and credit facilities and SME loans are all now likely to be eligible.

This change in approach follows extensive consultation led by the Commission and reflects the fact that many securitisations performed well throughout the recent financial crisis and were viewed as reliable sources of liquidity by many European market participants.

It also reflects a broader trend of regulators and policy recognising the role of securitisation in supporting the recovery of the real economy and consumer lending.

Once approved, the LCR rules will initially apply only to credit institutions, on both an individual and a consolidated basis, unless the competent authorities waive the application on an individual basis in accordance with the CRR. It will not apply to investment firms unless those form part of consolidated banking groups. Despite this initially limited scope the eligibility of securitisations has the potential to revive demand for such structures among bank investors (who are a significant investor class for securitisation) and thereby foster the recovery of the securitisation market.

- A wide range of ABS will potentially be eligible as Level 2B HQLA
- Minimum haircuts of 25% (for RMBS and auto receivables ABS) and 35% (for consumer and SME ABS) will apply
- Level 2B HQLA can make up a maximum of 15% of the overall liquidity buffer
- The LCR rules initially apply only to credit institutions but not investment firms (unless consolidated in a banking group)

The Commission is required to report by the end of 2015 on whether and how the LCR requirements should apply to investment firms. In the meantime, investment firms will remain subject to the national law of the Member States. It should further be noted that the Commission has an ongoing mandate to review the eligibility criteria and, in particular, it may add or remove asset classes from the list of eligible ABS.

Eligibility criteria

In order to be Level 2B HQLA, securitisation assets must meet (i) the general and operational requirements applicable to all HQLA, and (ii) the specific eligibility criteria for Level 2B securitisations contained in Article 13 of the LCR Delegated Act.

General and operational requirements

The general requirements broadly aim to ensure that each position included in the liquidity buffer is can be quickly monetised. In support of this, the rules require that instruments be freely and readily transferrable, are not subject to any security or encumbrances and that they are easy to value – either by reference to widely disseminated market prices or by using a simple formula based on publicly available inputs.

The rules also exclude from the liquidity buffer positions issued by the entities with "close links" to the credit institution itself. This includes its related persons or securitisation special purpose entities (SSPEs).

The operational requirements mandate that policies, limits and procedures be put in place to ensure that the liquidity buffer assets be appropriately diversified, readily accessible and segregated. Hedging of the market risk associated with the assets included in the liquidity buffer is generally permitted, provided that it doesn't result in the relevant position not being readily available for monetisation and that the potential costs of any broken hedge are properly accounted for in its valuation.

Eligibility criteria

The eligibility criteria specific to Level 2B securitisations fit broadly into 4 categories: (i) asset class; (ii) underlying asset features; (iii) structural features of the securitisation; and (iv) features of the specific securitisation exposure. We address each of these in turn below.

Eligible asset classes

Securitisations of the following asset classes will, subject to compliance with the other requirements noted in this briefing, be Level 2B HQLA:

- residential loans secured with a first-ranking mortgage granted to individuals for the acquisition of their main residence. Pools including buy-to-let mortgages would not, therefore, qualify as Level 2B HQLA;
- fully guaranteed residential loans;
- commercial loans, leases and credit facilities to finance capital expenditures or business operations (other than the acquisition or development of commercial real estate);
- auto loans and leases;
- loans and credit facilities to individuals for personal, family or household consumption purposes.

Resecuritisations and synthetic securitisations (in each case as defined in the CRR) are specifically excluded.

Underlying asset features

These criteria apply to the underlying pool of securitised exposures:

- ***Originator***: The originator of the underlying exposures must be a credit institution, an investment firm, or an undertaking whose principle activity is one of those listed in Annex I of CRD4.
- ***Homogeneity***: All exposures within the securitisation position must belong to only one of the listed asset categories, thus excluding mixed asset pools. The only exemption is made for residential mortgage loans pools which may include first-ranking residential mortgages and fully guaranteed residential loans.
- ***LTV/LTI limits***:
  - Residential mortgage loans secured with a first ranking mortgage satisfy either the LTV requirement under the Article 129(1)(d) of the CRR (broadly, a maximum 80% LTV) or an LTI requirement set out under the national law of the Member State in which the loan were originated (most useful for Dutch RMBS structures).
  - Fully guaranteed residential loans must satisfy the collateralisation and the average LTV requirements under the CRR, which are drafted largely to cater for French-specific residential property financing techniques.
- ***Type of borrower***: For SME exposures, at least 80% of the borrowers (as measured by reference to the portfolio balance) in the pool must be small and medium-sized enterprises at the time of issuance of the securitisation, and none of the borrowers can be a credit institution or an investment firm.
- ***Location of the borrower***: The securitised exposures must be loans to borrowers established or resident in a Member State. Note, however, that this requirement does not appear to apply to RMBS.

- ***Borrower credit checks***:
  - Where applicable, the borrowers under the underlying loans must have undergone a credit check that complies with applicable consumer credit directives or (in the case of RMBS) equivalent requirements in third.
  - For RMBS, the pool cannot include so-called "liar loans", i.e. loans which were marketed and underwritten on the premise that the loan applicant (or and intermediary) was made aware that the information it provided might not be verified by the lender.

  These criteria would exclude structures such as non-conforming UK RMBS. In addition, the requirement to comply with consumer credit rules in respect of auto receivable ABS sits awkwardly with the very real possibility that the obligor may well be a business. It is yet to be determined, therefore, whether ABS backed by commercial auto leases will be eligible. ABS backed by commercial loans are not typically seen in the market.
- ***Seasoning***: At the time of issuance of the securitisation, the borrowers or, where applicable, the guarantors, must have made at least one payment (this requirement does not apply to credit card receivables).
- ***Credit quality of exposures***: The exposures included in the underlying asset pool must not include (i) exposures to credit-impaired obligors (or guarantors), or (ii) exposures in default. In each case, the credit quality of exposures will be tested at the time of issuance of the securitisation or at the time of incorporation of the relevant exposure in the pool (the latter being the test for exposures added to the securitisation after issuance).
- ***No financial instruments or derivatives as exposures***: The underlying exposures must not include transferable financial instruments or derivatives. Financial instruments issued by the issuer or other parties within the securitisation structure and derivatives used to hedge currency and interest rate risk are, however, permitted.

In the context of ABS backed by auto loans/leases, there are also specific criteria that apply to the type of vehicles which may be financed and the type of related security, as well as ancillary services which may be provided as part of the relevant financing service (such as, for example, insurance and service products, additional vehicle parts, residual value of leased vehicles).

Structural features

In terms of the structural features, the LCR Delegated Act requires the following:

- The securitisation must be set up using a "true sale" structure that is not subject to severe clawback provisions or challenges in the event of the seller's insolvency.
- The transaction must provide for sequential amortisation, with no substantial cash trap at the issuer level on each payment date. Alternatively, where there is a revolving period, the transaction must provide for appropriate early amortisation triggers including at a minimum (i) deterioration in the credit quality of the underlying exposures; (ii) a failure to generate sufficient new assets of at least similar credit quality; and (iii) insolvency-related events in respect of the originator or servicer of the assets.
- The securitisation cannot be structured so as to "depend, predominantly, on the sale of assets securing the underlying exposures". This is a slightly strange formulation, as it suggest e.g. on an RMBS, that you may not depend on the sale of the underlying homes, and would be meaningless in the case of unsecured loans as underlying assets. It is possible that this was intended to exclude securitisations with embedded maturity transformations common in, e.g. CMBS transactions with large balloon repayments that depend on refinancing the underlying asset. This may be amended at some point in the future, but for the moment it will be important to watch how market practice around this provision develops.
- The servicing arrangements must ensure, at a minimum, that a default or insolvency of the servicer does not result in a termination of servicing. In practice, it would appear that standard servicer replacement provisions commonly included in ABS transactions should satisfy this requirement.
- The swaps and liquidity arrangements must, at a minimum, ensure that upon their default or insolvency, the relevant counterparty is replaced. Rated

securitisations typically include such provisions.

- Where the originator, original lender or sponsor is established in the EU, it complies with the retention requirements under the CRR. This requirement is a little bit confusing as most of the risk retention provisions in the CRR are articulated as obligations on an investing institution, rather than on the originator, sponsor or original lender. The point may be academic, however, because an investing credit institution concerned with whether a securitisation asset counts as HQLA for LCR purposes will also separately be concerned to ensure the risk retention provisions are complied with for regulatory capital purposes.
- Where the originator, original lender or sponsor is established in the EU, it complies with the disclosure requirements under Article 8b of the Credit Rating Agencies Regulation.
- Where the originator, original lender or sponsor is established outside the EU, it must make available comprehensive loan-level data of a standard generally accepted by market participants on a regular basis. This requirement is unclear, as the fundamental concepts such as the "market" by reference to which these standards are to be judged are unspecified. Presumably, however, where at least one of the originator, original lender or sponsor is established in the EU, this obligation would be met for all three via compliance with Article 8b by the EU-established party.

Securitisation exposure

The requirements applicable to the securitisation exposure itself look at the rating, tranche seniority, tranche size and the remaining weighted average life of the tranche:

- Only tranches at the highest level of seniority at all times during the ongoing life of the transaction for both interest and principal are eligible, though the customary super senior payments (e.g. swaps and expenses) are permitted.
- The tranche must be assigned a credit rating of at least credit quality step 1 (or an equivalent short term rating) by at least one nominated EU registered rating agency.
- The issue size of the tranche must be at least EUR 100 million (or an equivalent in domestic currency).
- The remaining weighted average life of the tranche must be 5 years or less. This is to be calculated using the lower of the securitisation's pricing prepayment assumption or a 20% constant prepayment rate (for which the credit institution must assume that a call will be exercised on the first permitted call date).

Comfort for investors

Most investment grade, rated ABS of the appropriate asset classes should be in a position to satisfy these requirements. It should be noted, however, that compliance with Article 8b of the CRA Regulation might present a logistical challenge for some asset classes such as, for example, credit cards.

That said, investors will of course be interested in the form and level of comfort available to them that particular securitisation assets will qualify as Level 2B HQLA.

This is an area that will need to be monitored, but on its face, it would appear that the credit institutions will likely end up undertaking diligence similar to the regulatory due diligence required under the CRR, AIFMD and Solvency II regimes. From a practical perspective, the asset and transaction documentation disclosure in securitisation offering documents will, with only minor modifications, generally be sufficient to allow investors to check the relevant sections of a prospectus against a "checklist" of eligibility requirements and satisfy themselves independently as to eligibility.

Next steps

Following publication of the final draft of the LCR Delegated Act on 10 October 2014, the European Parliament and the Council have three months (extendable by a further three months) in which to object.

Taking into account the objection period and the time required for industry preparations, the Commission's proposal suggests 1 October 2015 as the date from which the LCR requirements should apply.

From that date, the LCR will be phased-in, starting from a requirement to hold HQLA covering 60% of a credit institution's net liquidity outflows during a 30-day stress period in 2015. That figure will rise by 10% each year with a jump from 80% in 2017 to 100% in 2018, the final stage of implementation. That said, national competent authorities may phase in the requirement more quickly.

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