Finance for Europe

Association for Financial Markets in Europe

Briefing Paper **August 2017**

Article 17 Securitisation Regulation – an adjusted, forward-looking standard for legacy transactions and non-performing loans

Executive Summary

AFME supports the work undertaken by the European Commission and the co-legislators in reaching an agreement on the proposed regulation laying down common rules on securitisation (the "Securitisation Regulation") and creating a European framework for simple, transparent and standardised ("STS") securitisation.

However, Article 17 contains late additions to the text. These appear to us to be both retrospective in effect and have not been subject to an impact assessment or feedback from the industry. Article 17 as drafted will have serious implications for the securitisation market.

Article 17 of the Securitisation Regulation (see Appendix 1) contains:

- a new prohibition of *any* securitisation containing a "self-certified" residential mortgage including where the securitisation is not STS and where the securitisation refinances assets that had previously been financed via a securitisation; and
- requirements relating to credit-granting standards which will effectively prevent market participants from purchasing portfolios in the secondary market and remove securitisation as a viable financing option for such purchase.

We support the restrictions which currently apply across the EU on the origination of self-certified mortgages by lenders. Nevertheless, the securitisation market remains a crucial tool which enables investors to finance the purchase of legacy loan pools, both performing and non-performing. Prohibiting the use of securitisation will seriously harm the secondary market for legacy assets and purchased portfolios including non-performing loans ("NPLs"), and slow the general process of bank deleveraging. Article 17 as drafted is already creating uncertainty and market disruption.

The solution is:

- to adjust Article 17(2) to be forward-looking only; and
- to adjust the compliance standard in Article 17(3) to "taking reasonable steps".

These minimal adjustments are set out in Appendix 2. We ask that these be made before the final adoption of the texts and publication in the Official Journal.

If not amended, Article 17 will not only upend a stable and gradually recovering securitisation market but will also have the following damaging consequences:

- disqualify a high percentage of Europe's legacy loans from appearing in any securitisation issued after January 1, 2019. This includes many post-crisis, highly performing securitisations of legacy portfolios with long payment histories. These were priced, purchased and sold to investors with

a redemption date of 3, 5 or 7 years with the expectation of refinancing the securitisation between 2018 and 2022;
- curtail the available financing options for certain assets including NPLs and self-certified loans (the latter exist as a legacy product only), especially where the assets are being securitised by someone other than the original lender;
- damage confidence in the European securitisation framework by overturning investors' legitimate and reasonable expectations regarding the law and contractual arrangements entered into legally and in good faith for established, post-crisis transactions;
- damage especially the small group of investors with higher risk appetite for mezzanine tranches of residential mortgage-backed securities ("RMBS"), who hold the key to the distribution of risk out of the banking sector into the wider financial system;
- for the €1 trillion of NPLs weighing on Europe's banks, set inappropriate and impossibly high standards for due diligence which will limit the ability of investors to provide liquidity and capital to banks and national agencies who are seeking to re-organise and improve their balance sheets and capital positions through the securitisation market;
- specifically, new securitisation funding for many of Europe's government-sponsored "bad" banks such as Atlante in Italy and the National Asset Management Agency in Ireland will be prohibited after January 1st 2019; and
- hinder the prospects for recovery of the European securitisation market and significantly undermine the positive effects of the new securitisation framework by limiting financing options for prospective asset buyers.

Article 17(2): key concerns for legacy transactions

The Mortgage Credit Directive requires lenders to undertake a thorough affordability assessment based on information that has been verified by the lender. This operates as an effective ban on the origination of self-certified mortgages, and all Member States were required to apply this ban no later than 21 March 2016. A number of Member States had laws substantially to this effect well before that date.

However, self-certified mortgages still exist as a legacy product included in many portfolios underlying existing securitisations primarily in the UK but also in other European countries including Ireland, Spain and the Netherlands. We believe the volume across Europe of non-conforming RMBS with exposure to self-certified mortgages is in excess of €35 billion[1]. This figure is based on transaction information which explicitly discloses exposure to self-certified mortgages. It is likely that transactions in other jurisdictions also contain self-certified mortgages, but that these mortgages are not clearly identified as such in the documentation. Given the broad wording of Article 17(2), certain legacy loan products not considered traditional self-certified loans but marketed and underwritten on the described premise of possible non-verification of borrower information are likely to be within the Article's scope.

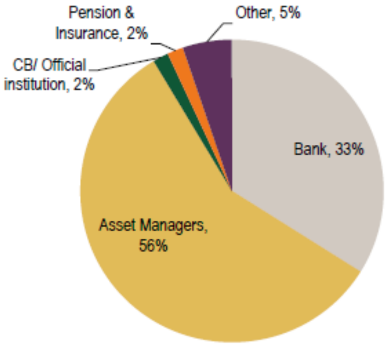
Furthermore, the broad wording of Article 17(2) could cause a larger part of the residential mortgage market to be captured unintentionally. In any case, the broad definition will require both originators and investors to re-examine every mortgage securitisation pool. The total RMBS issuance in Europe since 1st January 2013 is close to €400 billion, of which approximately €140 billion or 35% was placed with investors.

[1] Bank of America Merrill Lynch.

Many different types of investors from across Europe have invested in such transactions including asset managers, banks, central banks and pension funds and insurance companies[2]. In recent years asset managers have absorbed an ever-larger share of RMBS backed by non-conforming mortgages and loans. This is in line with overall policy direction to lighten banks' balance sheets and disperse risk throughout the financial system.

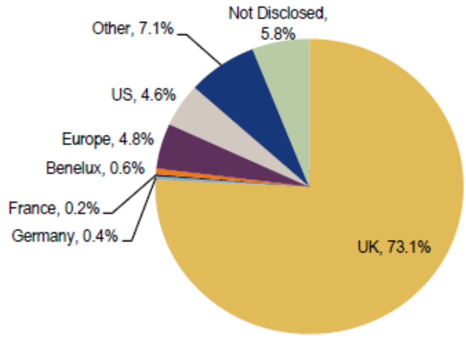
In terms of country distribution, while the UK investor share is large, many of the UK investors are asset managers who manage investments for EU and global clients, and many of the bank investors located in the UK are headquartered in other EU countries[3].

Chart 9: Investor distribution by type (placed volume-weighted)



Source: BofA Merrill Lynch Global Research

Chart 10: Investor distribution by geography (placed volume-weighted)



Source: BofA Merrill Lynch Global Research

The damaging effect of Article 17(2) on legacy transactions

We are very concerned that Article 17(2), which introduces a brand new prohibition on the securitisation of affected mortgages, will have a damaging impact on the EU economy. We understand that it was a late addition to the text and its impact on existing deals and legacy assets may not have been considered fully. We would therefore like to take this opportunity to provide feedback on its consequences.

As currently drafted, Article 17(2) will lead to large volumes of legacy mortgages returning to bank balance sheets where they will need to be supported by retail deposits, significantly constraining the ability of banks to lend to the wider economy in a way that is inconsistent with the collectively stated aims of the Securitisation Regulation and the Capital Markets Union project. It will also have the following damaging effects:

- investors often expect securitisations to refinance not just at maturity but at earlier call dates – the likelihood of such expectations being met will be negatively affected because such refinancing through securitisation will be prohibited for affected portfolios after 1st January 2019;
- this will increase the probability that the weighted average life ("WAL") of affected transactions will lengthen, with the result that margins will increase; this will affect disproportionately the lower mezzanine tranches where most of the investor risk-takers are concentrated and is where the originator most frequently holds the required 5% credit risk retention; many of these

[2] Bank of America Merrill Lynch.

[3] Bank of America Merrill Lynch.

investors are also key buyers of NPL portfolios that banks and national agencies are seeking to dispose of;
- the effects on WAL will vary from one transaction to another, depending on the seniority of the tranche, but in many cases the effect could be significant; secondary market spreads have already widened somewhat and investor uncertainty clearly exists;
- in the worst cases, the effect of extension in weighted average lives could cause the prices of affected securities to fall in light of the now seriously restricted refinancing opportunities for previously liquid and marketable securities, creating unwarranted mark-to-market losses for existing investors for reasons that would have nothing to do with the quality or structures of the securitisations. Such re-pricing will damage future investor appetite as has been seen in similar instances of mark-to-market repricing in the past;
- the ECB has acquired more than €24bn of RMBS and ABS through its ABS Purchase Programme ("ABSPP"). Article 17(2) will alienate precisely the type of investors that the EU securitisation market needs at a point in time when ECB is about to exit its purchase programme;
- create a hurdle to the reintegration into private markets of portfolios currently held by national agencies; and
- in the prudential context of bank resolution, Article 17(2) will create at the very least uncertainty and delay; at worst it could prevent a bank under financial stress from securitising its legacy mortgages in order to secure emergency funding from the ECB, its national central bank or private investors.

The heavy sanctions for breach of the Securitisation Regulation mean that the proposed final text will have a chilling effect on any transaction where there is the slightest risk of a portfolio containing a mortgage which could be in scope.

It is important to note that these transactions will not in any case qualify as STS securitisations. AFME has always fully supported their exclusion from STS. However, non-STS securitisations play an important role in offering an alternative financing option to the capital markets for portfolios that would otherwise have to be funded on bank balance sheets or by national agencies. Due to the interconnectedness of European institutions and asset finance, regulation of this scope and breadth affecting legacy loans will impede the important process of shifting assets from the balance sheets of Europe's banks to the capital markets, which is still at an early stage.

We hope that Article 17(2) is intended to apply only prospectively, in order to prevent disruption to affected market participants who have entered into contracts in good faith. Unfortunately, the wording of the text runs counter to this accepted principle of protecting legitimate transactions entered into on the basis of the law at the time.

Adjustment of this Article to ensure it only applies to loans originated prospectively is justified since many legacy self-certified mortgages have been seasoned for many years and continue to perform. Moreover, investors' willingness to invest in securities backed by such loans is premised on such sustained performance - not the underwriting by the original lender. There is no prudential or other reason for prohibiting their securitisation entirely, even if they may not have been originated in accordance with current underwriting standards or STS criteria.

Our proposed solution

Our suggested amendments to Article 17(2) address the issues set out above by applying the restriction only in respect of transactions involving affected loans made on or after the date of application of the Securitisation Regulation (1st January 2019), thereby ensuring that legacy assets can continue to be financed through securitisation.

Article 17(3): securitisation is a key tool in resolving the challenge of NPLs in Europe

Resolution of the large stocks of NPLs which currently sit on EU banks' balance sheets is a key area of focus for the EU authorities. The ECB has indicated that the scale of the issue is significant, with end-2016 figures referring to 107 significant institutions holding around €866 billion in gross impaired assets, and has recently published a report indicating that certain securitisation structures could be "highly beneficial in galvanising sales of NPLs and increasing the prices that investors are prepared to pay for them".[4]

In February 2017, Vice President Constâncio of the European Central Bank noted that securitisations complement NPL sales on several key fronts including the expansion of the "universe of distressed debt investors" through the sale of rated senior tranches and it also "offers another way through which governments may jump-start the NPL market, for example by co-investing, together with private investors in junior or mezzanine tranches."[5]

Further, the EBA in its December 2016 "Risk Assessment of the European Banking system" also commented that "more than one-third of EU jurisdictions have NPL ratios above 10% … improvements in asset quality are expected … but they will strongly depend on successfully tackling the impediments of NPL resolution."[6]

The July 2017 conclusions of the European Council and Council of the European Union on an "Action Plan to tackle non-performing loans in Europe" stressed that "a comprehensive approach combining a mix of policy actions … is the most effective way to address the existing stocks of NPLs as well as the emergence and accumulation of new NPLs … in particular in … development of secondary markets for distressed assets …".[7]

Lastly EU authorities have acknowledged the role that the capital markets (including securitisation) can have in terms of helping European banks overcome the challenges of NPLs, and the importance in this regard of improving the functioning of the secondary markets for NPLs. The European Commission is currently consulting on various matters related to NPLs including the "practical problems and restrictions that might currently hamper the development of secondary markets for NPLs, and loan contracts more generally, with a view to potentially removing them where appropriate".[8] The challenges to this development are described to include, amongst other things, information

[4] https://www.ecb.europa.eu/pub/fsr/shared/pdf/sfcfinancialstabilityreview201705.en.pdf?af953cafd6561fd288c85126163c7c04

[5] See also Appendix 3.

[6] Linked here.

[7] Linked here.

[8] Linked here.

asymmetries between sellers and buyers. The Commission has expressly acknowledged in this context that "potential buyers tend not to have access to reliable, granular, readily available standardised information on asset quality and loan tapes in banks". As drafted, Article 17 does not reflect this reality and does not allow for appropriate adjustment of the verification required where such information deficiencies exist.

Fundamentally, AFME agrees that it is an important policy objective to foster the development of secondary markets in Europe for NPL transactions. This should increase the incentives both for banks or national agencies to sell NPLs, and for more investors to acquire and manage NPLs, in secondary markets in which securitisation plays a crucial role. Article 17 could severely compromise this in practice.

The pan-European nature of the problem

NPL resolution in the Euro area has been slow since reaching a peak in 2013. The ratio of NPLs to all loans on banks' balance sheets is over 20% on average across six Euro area countries: Cyprus, Greece, Italy, Ireland, Portugal and Slovenia.[9] Banks directly supervised by the ECB held €921 billion of such troubled loans at the end of September 2016, representing 6.4% of total loans and equivalent to nearly 9% of the Euro area GDP[10].

There is a wide gap in the NPL market between bid and ask prices. The data on the size of this gap is scant but estimates suggest that for a fully collateralised NPL a private investor requires a discount to book value of 40% or more - solely due to the cost, time and uncertainty of recoveries.
Because the definition of securitisation is extremely broad[11], Article 17 risks prohibiting any financing of NPL portfolios post 1 January 2019. Most purchasers of NPLs require financing. To the extent there is no financing not only will bid prices for NPL portfolios fall due to increased pressure on NPL valuations versus book values, but also there will be significantly less capacity and even fewer transactions than currently exist. Resolution of banks' balance sheets will take even longer and in many instances banks may be left with NPLs for many more years, contrary to stated policy objectives.

Article 17(3) sets an inappropriate and impossibly high standard for purchasers of NPLs and other portfolios of loans

While a version of Article 17 was included in the Council negotiating stance document finalised at the end of 2015, the concerns raised by market participants on numerous occasions with respect to the need for an adjusted compliance standard under Article 17(3) unfortunately are not reflected in the adopted draft text. Although the text of Article 17(3) presents challenges for the securitisation of any acquired portfolio – particularly where the original lender either no longer exists or is not part of the securitisation process – recent increased focus on NPLs and the need to develop a secondary market for such assets has put a spotlight on the challenges that this Article 17 will present for transactions involving an acquisition of NPLs and intended securitisation financing.

Article 17(3) creates a standard of compliance in the context of purchased portfolios which is too high for market participants to meet in a number of common circumstances that are particularly prevalent in NPL pools.

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[9] See Appendix 4.

[10] ECB Supervisory Banking Statistics.

[11] Article 4(61) CRR, linked here.

As previously acknowledged by the European Commission, purchasers of NPL portfolios who wish to finance through securitisation are less likely to receive sufficient information to confirm the matters referred to in Article 17(1). In particular, this may be the case where either:

- the originator of the asset is no longer operating or even in existence; or
- there have been one or more prior transfers of ownership so that the purchaser has no contact with the original lender because it is too far away in the "chain" of purchasers.

Available origination information related to the seasoned assets is likely to be out-of-date, limited in its scope or otherwise incomplete so that the purchaser cannot independently verify whether the asset creator fulfilled the requirements in Article 17(1). Many legacy assets in scope of Article 17 were originated many years ago; as a credit matter, the actual history of performance – or non-performance – since then is considered to be a far more important risk criterion than assessments that were made at origination.

Further, EU regulated investors in a securitisation which funds a NPL purchase are required under Article 5(1) of the Securitisation Regulation to verify that the originator or original lender established in the EU complies with Article 17(1). It is not entirely clear how this should operate in circumstances in which the purchaser of the portfolio (now treated as an "originator") has acquired a "legacy" asset, although presumably information would be required by investors with respect to the asset creator's credit granting standards. This may not be possible for the reasons outlined above.

Once again, the heavy sanctions for breach of the Securitisation Regulation by originators and the consequences of breach by investors will have a chilling effect on any transaction where there is any issue with respect to verifying the credit-granting standards matters referred to in Article 17(1).

Our proposed solution

Our suggested amendments to Article 17(3) are intended to address these issues by allowing for a "taking reasonable steps" compliance standard to be applied in respect of entities which do not create the assets and, where verification is not possible, allowing for compliance through clear communication of this fact to investors.

Conclusion

As drafted, Article 17 risks splitting up markets, concentrating funding sources and reducing access to capital. We believe that the most appropriate solution is to introduce small amendments to Article 17 before the final adoption of the texts and publication in the Official Journal to remedy these unintended consequences.

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Appendix 1

Proposed final text of Article 17
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.

2. 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 by the loan applicant might not be verified by the lender.

3. 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.

Appendix 2

Proposed amendments to Article 17
Criteria for credit-granting
[To be reviewed by members]

1. Subject to each of paragraphs 3 and 4, o~~O~~riginators, 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.

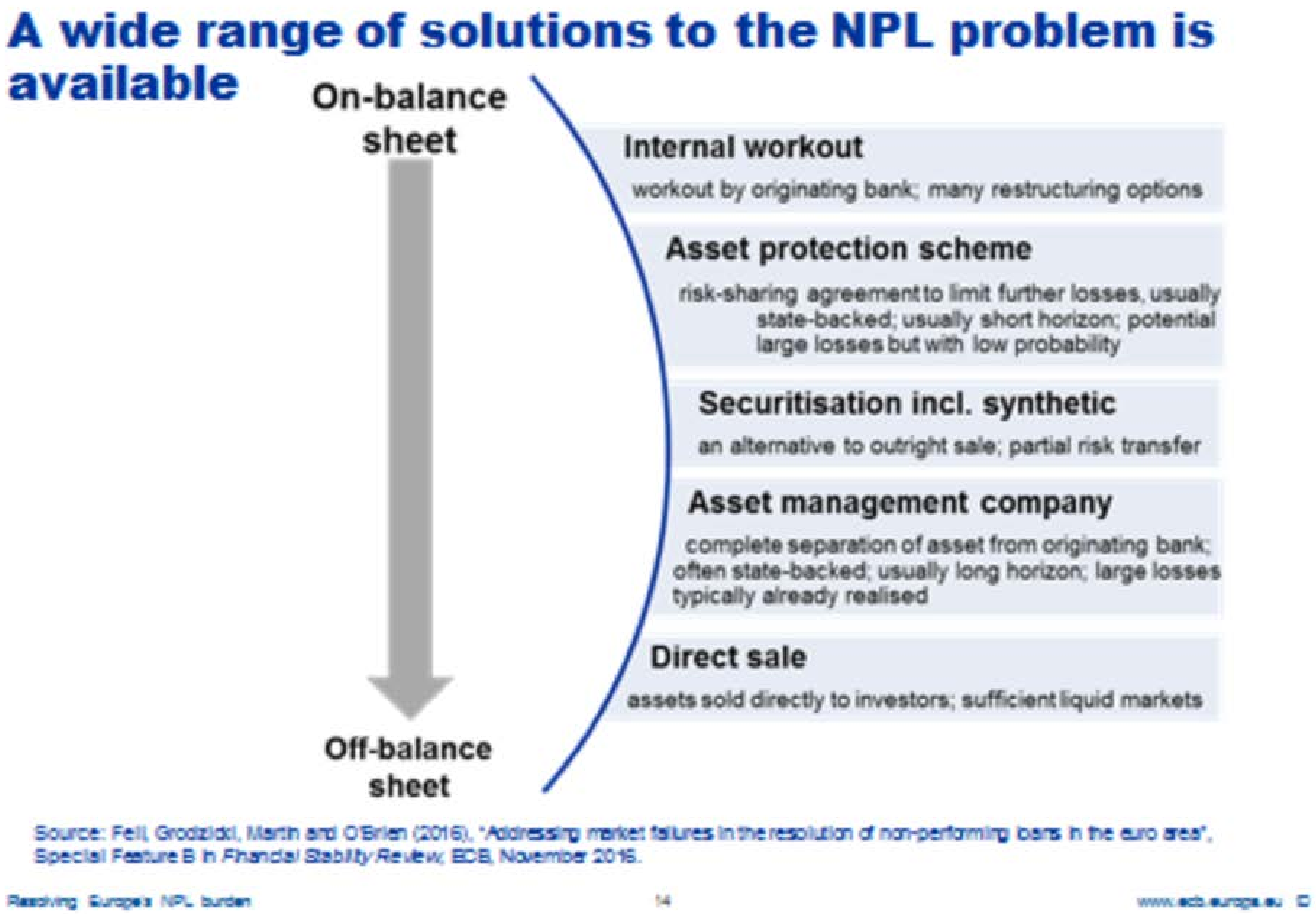
2. Where the underlying exposures of securitisations are residential loans, the pool of those loans shall not include any loan made on or after [1 January 2019 [*application date*]] that is marketed and underwritten on the premise that the loan applicant or, where applicable, intermediaries were made aware that the information provided by the loan applicant might not be verified by the lender.

3. In the case of~~Where~~ an originator which purchases a third party's exposures on~~for~~ its own account and then securitises them or of a sponsor, the obligations in paragraph 1 shall be satisfied by that originator or sponsor ~~shall~~ taking reasonable steps to verify that the entity which was, directly or indirectly, involved in the original agreement which created the obligations or potential obligations to be securitised fulfills the requirements in accordance with ~~the first~~ paragraph 1 or, where that verification is not possible, by clearly communicating this fact to the investors or potential investors.

4. The obligations in [each of] paragraph[s 1 and] 3 shall not apply in respect of any exposure originated prior to [1 January 2019 [*application date*]].

<u>**Appendix 3**</u>

Extract from slides presented by by Vítor Constâncio, Vice-President of the ECB at Bruegel on "Tackling Europe's non-performing loans crisis: restructuring debt, reviving growth" Brussels, 3 February 2017 (linked here)

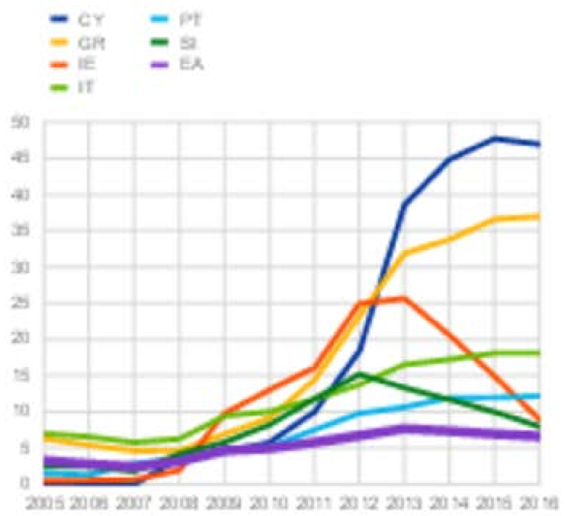


Appendix 4

Extract from slides presented by by Vítor Constâncio, Vice-President of the ECB at Bruegel on "Tackling Europe's non-performing loans crisis: restructuring debt, reviving growth" Brussels, 3 February 2017 (linked here):

NPL resolution in the euro area has been slow

NPL ratios in Europe have slowly fallen from the 2013 peak



Source: World Bank, IMF Financial Soundness Indicators, ECB

Note: Country samples and methodological differences related to NPL definitions or the consolidation scope can explain differences in ratios with respect to supervisory statistics

IMF data	Average NPL ratio (2007)	Average NPL ratio (2016)
6 EA countries	4.8	22.8
EA	2.4	6.6
UK	0.9	1.0
US	1.4	1.5

- NPL stock: a legacy from the crisis
- Peak NPL level in the euro area reached in 2013
- NPL resolution is slower in many countries facing high NPL levels

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