German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on the homogeneity of underlying exposures in securitisation (EBA/CP/2017/21)

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Comments on **the homogeneity of underlying exposures in securitisation**

General Remarks

The goal of the homogeneity requirements is to enable investors to perform a robust assessment of the securitised underlying exposures within the due diligence process. To make sure that this goal is achieved, the pool of securitised exposures is to be homogenous in terms of the underlying risks (in particular, credit risks) and cash flow characteristics. For investors' due diligence process, it is important to have a clear understanding of the underwriting and servicing standards and the risk factors that significantly affect the similarity of the risk profiles and cash flow characteristics.

On the other hand, a fundamental requirement for investors is to have diversified portfolios and avoid excessive concentrations. Furthermore, investors have an interest in transactions reaching certain volumes in order to achieve a decent level of liquidity in the secondary markets.

To align these contradicting principles without lowering the homogeneity requirements, we propose that similar underwriting standards, uniform servicing procedures and the relevant risk factors may also be applied to sub-portfolios separately as long as these sub-portfolios (together forming a transaction) all belong to one asset category and investors have full transparency about the underlying exposures in each of these sub-portfolios in terms of the underlying risks and cash flow characteristics.

In that sense, as we see it, portfolios that display different risk or cash flow characteristics in relation to certain risk factors that have "to be considered" should, nevertheless, be regarded as homogenous as long as the composition of the individual sub-portfolios is static and their respective risk or cash flow characteristics are known. This should also apply to the securitisation of revolving portfolios, where strict replenishment requirements rule out the risk or cash flow characteristics of the sub-portfolio changing significantly. Accordingly, in the case of sub-portfolios with different characteristics regarding one factor, the risk factor should only be considered "relevant", and thus the whole portfolio deemed non-homogenous, if either the composition of these sub-portfolios can change beyond an acceptable level or the risks or cash flow characteristics of the corresponding sub-portfolios cannot be determined in advance.

We are aware that in this case the investor must make a more differentiated assessment of the securitised portfolio. However, as it increases the investment opportunities of investors, it can be assumed that investors will be prepared to accept this additional expense. Additionally, due to the extensive due diligence required by investors, as set out particularly in Article 5 of the STS Regulation, they should at the same time be able to do so.

This approach would better reflect the market practice where pools of originator exposures that belong to the same asset category are securitised. Typically, this is found in, for example, auto lease transactions where finance instalments and corresponding residual values form a common portfolio. According to a strict interpretation of the criteria proposed by the EBA, this portfolio would be inhomogeneous because it encompasses diverse types of facilities with diverse risk and cash flow characteristics. With the application of the relevance criterion as proposed by us, it would, nevertheless, be possible to consider the securitised portfolio as homogeneous because the risk characteristics of the two sub-portfolios do not change beyond an acceptable limit even if the securitisation is revolving. This assessment is reinforced by the fact that the STS criteria already capture such structures with respect to on-sale risks (Article 20 (13)

and 24 (11) STS Regulation). It would thus be counterproductive if such portfolios could not comply with the STS criteria simply because they are not regarded as homogeneous.

We fear that the approach proposed by the EBA might exclude well-established securitisations from the STS regime because it would not be cost-effective and economically beneficial to securitise each sub-pool separately. The reason is that for each transaction a separate securitisation documentation, separate prospectus, separate legal opinions, separate assessments by mandated rating agencies and separate swap contracts, etc. would be necessary. The duplication of costs would nullify scale effects. Hence, the issuance of STS securitisations would in many cases be uneconomical although a simple assessment of sub-portfolios within a robust due diligence process would be feasible. Thus, it should also be admissible for the homogeneity requirements to be met at sub-pool level according to the same or similar underwriting and servicing standards and relevant risk factors even if the homogeneity requirements were not met on the entire securitised pool, as long as the overarching principle of the simple assessment of the securitised sub-pools is not endangered and as long as all exposures of the entire pool belong to the same asset category.

Comments on **the homogeneity of underlying exposures in securitisation**

Questions

Q1: Do you agree with the focus of the RTS, general approach and underlying assumptions on which the RTS are based? Does the proposed approach provide sufficient clarity and certainty on the interpretation and application of the criterion of homogeneity?

Clarity and certainty in relation to the relevance of risk factors are not sufficiently provided. An over-strict definition of STS criteria could lead to a fragmentation of the market, make a good part of the established programmes non-compliant and thus undermine the goal of increasing acceptance of securitisations in Europe. From an investor's perspective, the selection of one or more relevant risk factors by the originator cannot replace the investor's due diligence, even if the (non-)selection is justified by the originator. However, such selection harbours the risk that different national supervisors of investors might not follow the rationale behind the selection and challenge the STS status. Although the STS Regulation envisages a procedure for solving such conflicts, there remains a risk that securitisation investments may be re-qualified. In this case, regulated investors might not only be exposed to market value risk, but may also be forced to sell such securities in a fire sale. On the other hand, the originators also face severe damage and reputational risk – notwithstanding any sanctions they might be exposed to. We fear that the uncertainty in determining a reliable homogeneity criterion will deter originators and investors from investing in securitisations.

Q2: Do you agree with the assessment of the homogeneity of underlying exposures based on criteria specified under (a) to (d)? Should other criteria be added or should any of the criteria be disregarded?

A more flexible approach should be applied. This can be achieved by allowing originators to form sub-pools with similar underwriting standards and uniform servicing standards within their transaction and apply the relevant risk factor separately to each sub-pool. As a consequence, the differences for underwriting and servicing standards between sub-pools would have to be made transparent and the rationale for choosing one or more risk factors for each sub-pool would also have to be given separately. To warrant that the respective sub-portfolios have a sufficient volume of securitised exposures in a transaction a minimum threshold could be envisaged. As already pointed out in the General Remarks, portfolios that display different risk or cash flow characteristics in relation to a certain risk factor that "needs to be considered" should, nevertheless, be regarded as homogenous as long as the composition of the individual sub-portfolios is static and their respective risk or cash flow characteristics are known. This means that the risk factor in question should in this case not be regarded as relevant. This should also apply to the securitisation of revolving portfolios, where strict replenishment requirements rule out the risk or cash flow characteristics of the sub-portfolio changing significantly. Accordingly, in the case of sub-portfolios with different risk or cash flow characteristics for one factor, the risk factor should only be considered "relevant", and thus the whole portfolio deemed non-homogenous, if either the composition of these sub-portfolios can change beyond a certain acceptable limit or the risks or cash flows of the corresponding sub-portfolios cannot be determined in advance. In any case, there should be at least

clarification for auto and equipment lease transactions containing guaranteed residual values that the relevant risk factors will only apply to the lease instalments and that the claims against the guarantor or repurchaser may be disregarded with respect to the homogeneity criterion.

Furthermore, it would be helpful if a threshold [of, for example, 5-10%] were introduced that would allow having a small portion of the transaction not subject to the risk factor consideration. On the one hand, this would not materially impact the assessment of the investor; on the other hand, this may significantly lower the administrative efforts on the originator side.

Q3: Are there any impediments or practical implications of the criteria as defined? Are there any important and severe unintended consequences of the application of the criteria?

As outlined under question 2, a more flexible approach should be applied to avoid the exclusion of well-established securitisations such as many Auto-ABS that are deemed homogenous pursuant to the ECB eligibility criteria as collateral for Eurosystem credit operations. In general, we appreciate EBA's set of criteria and support the approach. However, this approach should be extended to homogenous sub-portfolios that do not fulfil the homogeneity requirements at the level of the entire securitised pool as long as securitised exposures belong to the same asset category and as long as the overarching principle to enable the performance of robust due diligence is not endangered. A very important indication that this overarching principle is not breached could be the ECB eligibility of ABS whose securitised pool has to be homogenous in order to be eligible as collateral for Eurosystem credit operations. Furthermore, we welcome it that the list of asset categories is not exhaustive.

Q4: Do you agree that when considering the relevance of the risk factors, the asset category, type of securitisation (non-ABPC or ABCP), and specific characteristics of the pool of exposures, should be taken into account? Should other elements be considered as important determinants of the relevance of the individual risk factors?

See our answers to Q2 and Q3. The proposed risk factors would in this way seriously have the potential to point to a misleading initial assessment of homogeneity of pools. It might prevent a large number of securitisation transactions from being eligible for the STS label for no reason, especially leasing transactions with guaranteed residual values.

Q5: Do you agree that the same set of criteria should be applied to non-ABCP and ABCP securitisation? Or do you instead consider that additional differentiation should be made between criteria applicable to non-ABCP and ABCP securitisation, and if so, which criteria?

We agree. Although there are substantial differences in the respective structures of non-ABCP (i.e. term ABS, sometimes revolving, sometimes non-revolving) and ABCP (warehouse financing, revolving), they share certain basic features. Under both types of transaction, assets are sold to an SPV to prevent commingling risks with the asset seller and investments are ultimately bankruptcy-remote, backed by the

value of those assets. As already pointed out in the RTS, the homogeneity criterion for ABCP should apply to the transaction level only (i.e. the liquidity facility).

Q6: Do you agree with providing a list of asset categories in the RTS? Do you agree with the asset categories listed? Should other asset categories be included or some categories be merged? For example, should separate asset categories of project finance, object finance, commodities finance, leasing receivables, dealer floor plan finance, corporate trade receivables, retail trade receivables, credit facilities to SMEs and credit facilities to corporates, be included? Please substantiate your reasoning.

We strongly recommend including micro-, small- and medium-sized enterprise and corporate exposures in one single asset category.
Furthermore, as we understand it, credit facilities to SMEs are included in Article 2 (d).

Q7: Do you agree with the definitions of the asset categories provided? For example, do you consider that the asset category of credit facilities to SMEs and corporates should be further specified and for the SMEs should refer to the definition provided in the Commission Recommendation 2003/361/EC, or should other reference be used (for example to Art. 501 of the CRR)? Please substantiate your reasoning.

The European corporate world is standardised to such a small extent that a strict definition could rule out all types of ABS based on SMEs, a sector that proved stable during and after the financial crisis. We do not believe that hard criteria definitions as defined in Commission Recommendation 2003/361 /EC are suitable as criteria for determining homogeneity in underlying pools of assets. In addition, it is important to avoid an overly granular classification.

Q8: Do you agree with the approach to determination of the homogeneity based on the risk factors, and the distinction between the concept of risk factors to be considered for each asset category, and relevant risk factors to be applied for a particular pool of underlying exposures, as proposed? Are there any impediments or practical implications of the risk factors as defined? Are there any important and severe unintended consequences of the application of the risk factors?

As already pointed out in our General Remarks and our answers to Q 1 and 2, determination of the "*relevant*" risk factors is not clear. As we see it, portfolios that display different risk or cash flow characteristics in relation to a certain risk factor that "needs to be considered" should, nevertheless, be regarded as homogenous as long as the composition of the individual sub-portfolios is static and their respective risk or cash flow characteristics are known. This should also apply to the securitisation of revolving portfolios, where strict replenishment requirements rule out the risk or cash flow characteristics of the sub-portfolio changing significantly. This means that the risk factor in question should in this case not be regarded as relevant. Accordingly, in the case of sub-portfolios with different risk or cash flow characteristics for one factor, the risk factor should only be considered "relevant", and thus the whole

portfolio deemed non-homogenous, if either the composition of these sub-portfolios can change or the risks or cash flows of the corresponding sub-portfolios cannot be determined in advance.

Q9: Do you agree with the distribution of the risk factors that need to be considered for each asset category, as proposed? What other risk factors should be included for consideration for which asset category?

We disagree with the proposed set of risk factors for asset category (d). In particular, a certain variation in type of credit facility, type of repayment, jurisdiction and governing law is not detrimental to a homogeneous pool. We are of the opinion that such variations are generally accepted practices and, as such, accepted by a broad investor base. As stated in the rationale behind the RTS (see 12.e), the EBA's intention is not to impose additional requirements on the market. We would, thus, welcome a less strict regulation on this point. However, this problem should be solved by allowing the "sub-portfolio approach".

Q10: Do you agree with the definition of the risk factor related to the governing law, which refers to the governing law for the contractual arrangements with respect to the origination and transfer to SSPE of the underlying exposures, and with respect to the realisation and enforcement of the credit claims? Do you consider the risk factor of the governing law should be further specified, or further limited (e.g. to the realisation and enforcement of the financial collateral arrangements securing the repayment of the credit claims)?

If the EBA decides to include the risk factor related to the governing law as proposed in the consultation paper, potential securitisation of European portfolios would be greatly restricted. At least for asset category (d), the European Economic Area, including Switzerland and the UK, should be regarded as one area.

Q11: Do you consider prepayment characteristics as a relevant risk factor for determining the homogeneity? If yes, based on which concrete aspect of the prepayment characteristics of the underlying exposures should the distinction be made, and for which asset categories this risk factor should be considered and should be most relevant?

Prepayments depend to a great extent on current market conditions and might be quite volatile over time. Also, from a pure risk perspective, prepayments reduce credit risks in typical ABS/MBS securitisations. Furthermore, if two different jurisdictions have equivalent prudential regimes, then there is no additional risk. Therefore, we do not support prepayment characteristics as an additional risk factor.

Q12: Do you consider seniority on the liquidation of the property or collateral a relevant risk factor for determining the homogeneity? If yes, do you consider the distinction between the credit claims with higher ranking liens on the property or collateral, and credit claims with no

Comments on **the homogeneity of underlying exposures in securitisation**

higher ranking liens on a different property or different collateral, as appropriate for the purpose of determination of homogeneity?

No. Homogeneity could be ensured for senior and junior mortgages if pools are structured that way (e.g. 100% first lien or 100% second lien). Therefore, the distinction between the credit claims is not suitable in this context. Again, the risk of second lien pools is substantially higher, but could equally qualify as a homogeneous pool. Also, national differences (for example, due to tax laws) may cause second liens to be more or less prevalent.

Q13: Do you agree with the approach to determining the homogeneity for the underlying exposures that all do not fall under any of the asset categories specified in the Article 3?

Although in this case all the risk factors have to be taken into account, the approach opens up a possibility to determine the homogeneity for portfolios that cannot be subsumed under any of the given asset classes that works quite well if our proposed amendments are taken into consideration.

Q14: Do you believe that materiality thresholds should be introduced with respect to the risk factors i.e. that it should be possible to consider as homogeneous also those pools which, while fully compliant with requirements under Article 1 (a), (b) and (c), are composed to a significant percentage (e.g. min 95% of the nominal value of the underlying exposures at origination), by underlying exposures which share the relevant risk factors (e.g. by 95% of general residential mortgages with properties located in one jurisdiction and 5% of income producing residential mortgages located in that and other jurisdictions)? Please provide the reasoning for possible introduction of such materiality thresholds.

As already pointed out in our answer to Q 2, it would be helpful if a threshold [of, for example, [5-10%] were introduced which would allow having a small portion of the transaction not subject to the risk factor consideration. On the one hand, this would not materially impact the assessment of the investor; on the other hand, this may significantly lower the administrative burden for the originator. Thresholds would be in the interest of investors and originators, given the strict risk factors as a constraint on generating a granular portfolio of homogeneous assets. For example, if a pool is in general uncollateralised, a certain amount of collateralised assets is not going to deteriorate the performance of the pool. A situation in which one single misrepresented exposure has the potential to infect a whole portfolio as non-homogeneous should be avoided at all times.

Q15: Alternatively, do you see merit in introducing synergies with IRB modelling, enabling the IRB banks to rely on risk management factors validated for modelling purposes, when assessing the similarity of the underwriting standards, or assessing relevant risk factors? Please provide the reasoning and examples for possible introduction of such synergies.

We do not support the recognition of risk management factors validated for modelling purposes, as this would distort the level playing field even further.

Comments on **the homogeneity of underlying exposures in securitisation**

Q16. Which option from the two (the existing proposal as described in this consultation paper, and the alternative option as described in this box) is considered more appropriate and provides more clarity and certainty on the determination of homogeneity? Please substantiate your reasoning.

If we had to choose, we would prefer the alternative option. However, having said that, we also acknowledge less legal certainty and the risk that a competent authority may not share ex-post the originator's opinion about having a homogeneous pool. Therefore, we would prefer the following "sub-portfolio approach":

The homogeneity requirement should be deemed fulfilled as well if the pool of securitised exposures consists of homogenous sub-portfolios that all belong to the same asset category and that can be easily assessed even if the entire pool did not fulfil the homogeneity requirements. This would better reflect the market practice where pools of originator exposures that belong to the same asset category are securitised. Otherwise many well-established securitisations might be excluded from the STS regime, because it would not be cost-effective and economically beneficial to securitise each sub-pool separately. The reason is that for each transaction a separate securitisation documentation, separate prospectus, separate legal opinions, separate assessments by mandated rating agencies and separate swap contracts, etc. would be necessary. The duplication of costs would nullify scale effects. Hence, the issuance of STS securitisations would in many cases be uneconomical although a simple assessment of sub-portfolios within a robust due diligence process would be feasible.

Accordingly, a paragraph 2 should be added to Article 1, stating that the underlying exposures will be deemed homogenous as well where they consist of analysable sub-pools of underlying exposures that are grouped according to the same or similar underwriting and servicing standards and relevant risk factors even if the homogeneity requirements are not met on the entire securitised pool, as long as the overarching principle of the simple assessment of the securitised sub-pools is not endangered and as long as all exposures of the entire pool belong to the same asset category. To ensure that the sub-pools have a sufficient size for a simple and economical assessment, a minimum threshold value could be envisaged.

Q17: Please provide an assessment of the impact of the two proposed options, on your existing securitisation practices and if possible, provide examples of impact on existing transactions.

At the investor level, there would be no difference between the existing procedures. Credit analysis processes would be the same as stipulated (among other things) by Article 405 to 409 CRR.

At the level of the originator, the criteria under Option 1 could lead to more concentrated transactions in the market to comply with the defined risk factors. One member bank even stated that none of its synthetic SME and corporate exposure securitisations would meet the requirements on homogeneity according to Option 1. This could expose investors to additional risks even if the pool is homogeneous and a transaction is classified as STS.
Option 2 would at least allow the bank to present good reasons why it would consider these pools as homogeneous. However, even under Option 2, many transactions that are well established in the market

will be excluded from the STS regime. Thus, as proposed under Q16, fulfilment of the homogeneity requirements at sub-pool level as well should be allowed even if the entire pool did not fulfil the homogeneity requirements, as long as the overarching principle of the simple assessment of the securitised sub-pools is not endangered and as long as all exposures of the entire pool belong to the same asset category.

Q18. Alternatively, do you believe that a hybrid option, combining the existing proposal and the alternative proposal, would be most appropriate? The hybrid option could envisage that all the risk factors would need to be taken into account in the underwriting, and for those risk factors that are not taken into account in the underwriting, (i) either adequate justification would need to be provided that it is not required for the purpose of the homogeneity, (ii) or if the justification cannot be provided, the risk factor would still need to be taken into account when determining the exposures in the pool (on the top of the requirements related to underwriting, servicing, and asset category). Or, should other hybrid option be envisaged? Please substantiate your reasoning.

As pointed out throughout our comments, Option 1 does not make sense for determining homogeneity and in fact raises the spectre of misalignment within the meaning of STS. However, if the EBA would prefer to have Option 1 included in some form, a hybrid approach would probably be a possible compromise. Something along the lines of "comply or explain" could maximise transparency for all parties involved. Definition of an even more granular list of categories and factors should be avoided, as this would adversely affect the creation of granular, homogeneous pools. However, the additional allowance to enable the fulfilment of the homogeneity requirements at sub-pool level, as proposed under Q16, based on the overarching principle of the simple assessment of the securitised sub-pools and on condition that all exposures of the entire pool belong to the same asset category, would be the most flexible approach that best reflects the current market practice of well-established securitisations.

Q19. What are the advantages, disadvantages and unintended consequences of this alternative option, in particular compared to the existing proposal?

The key concern is to balance legal certainty (Option 1) and flexibility (Option 2). See also our answer to Question 18.

Q20. Are there any impediments or practical implications of this alternative option as defined? Are there any important and severe unintended consequences of the application of this option?

As we see it, the problem with Option 2 is that it grants much greater discretion to national supervisors. This could lead to competitive distortions. Yet we would, on balance, rather prefer the alternative option to Option 1, as the alternative option, from our point of view, is more in line with current securitisation origination in Europe. Nevertheless, allowing the "sub-portfolio-approach" proposed by us would even better reflect the current market situation. Therefore, we advocate allowing – under certain conditions - fulfilment of the homogeneity requirements at sub-portfolio level.