

M&G INSTITUTIONAL Investment intelligence

Simple, transparent and standardised: the changing shape of securitisation

April 2019

- New regulation intended to improve investor confidence in senior, high quality European ABS is now in force
- Simple, transparent and standardised (STS) securitisations offer Solvency II-regulated insurers access to certain senior securitised debt at similar capital charges to bonds
- Investors also benefit from new, more stringent transparency, risk retention and due diligence obligations on sponsors and originators



James King
Fund manager

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Wherever past performance is shown, please note that this is not a guide to future performance.

New European Union regulations focusing on securitisation products came into effect on 1 January 2019. The initial proposal was published in 2015 following an EU decision to look at improving market confidence in high-quality securitised products.

For insurance companies specifically, there was a retrenchment of these products from portfolios following the global financial crisis, due in large part to the lack of certainty in what underlying assets formed the securitisations. This was of course catalysed by the introduction of Solvency II in 2016, which classified securitisations into Type 1 or Type 2 and put stringent capital requirements on insurers investing in most of this asset class.

The new regulations lay down a general framework for securitisation. They also create a specific framework for simple, transparent and standardised securitisations, which benefit from preferential capital treatment for insurers, banks and investment firms.

The regulation covers a number of topics, but in summary it introduces a single set of regulatory requirements for investors due diligence.

Additionally, it introduces a direct requirement for risk retention and data transparency obligations on originators, sponsors or original lenders for new transactions.

Points to note

- Senior, high quality, STS-labelled securitisations receive preferential capital rate charges
- Originators, sponsors and issuers are responsible for designation of the STS label, although able to outsource certification to Third Party Verifiers (TPVs)
- Under the new securitisation regulation, all securitisations are subject to risk retention, transparency and due diligence obligations
- Investors may outsource securitisation due diligence to an investment manager
- STS exclusions include commercial mortgage-backed securities, collateralised loan obligations and non-performing loans (NPLs)

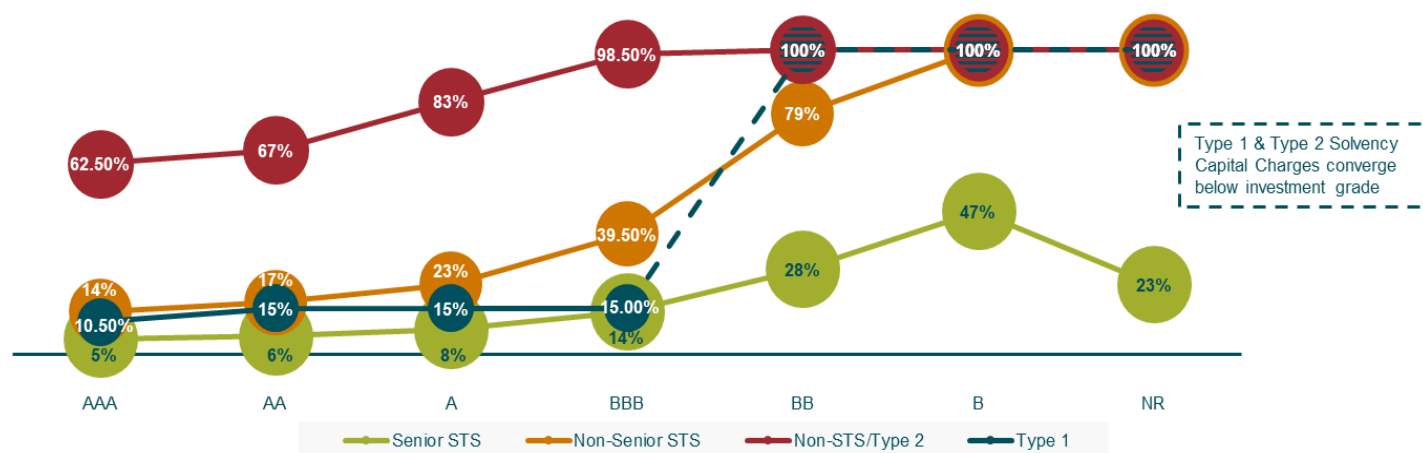
STS labelling

The STS framework seeks to mitigate uncertainties in the securitisation process, assist robust due diligence with the intention to boost confidence in high-quality securitisations, and redress the current penal rates attributed to most ABS, particularly for insurers.

Some of the eligibility requirements for STS securitisations are as follows:

<p>Simplicity</p>	<p>The originator, sponsor and Securitisation Special Purpose Entity ("SSPE") involved in an STS securitisation must be established in the EU. The securitisations must be:</p> <ul style="list-style-type: none"> • Backed by pools of exposures that are homogenous in asset type • At the time of transfer into the securitisation, no loans should be in default or constitute exposures to credit-impaired obligors <p>The following types of securitisations will not qualify as STS:</p> <ul style="list-style-type: none"> • Synthetic securitisation (must be true sale) • Actively-managed portfolios of underlying assets (this is aimed at keeping the underlying exposures transparent, allowing investors to effectively assess the credit risk of the underlying pool prior to making their investment decisions) • Commercial mortgage-backed securities (CMBS) • Non-performing loans and residential mortgage-backed securitisations of self-certified mortgages granted after 20 March 2014
<p>Transparency</p>	<p>Must provide historical data on default and loss performance to investors. This data shall cover a period of at least five years, and:</p> <ul style="list-style-type: none"> • There must be external verification of a data sample by an appropriate and independent party • Must provide investors with a liability cash flow model, both before pricing the securitisation and on an ongoing basis
<p>Standardisation</p>	<p>The interest rate and currency risks must be mitigated and the mitigation measures disclosed:</p> <ul style="list-style-type: none"> • The referenced interest payments must be based on generally-used market interest rates • The documentation must set out clearly what actions may be taken in relation to delinquency and / or default of debtors

Figure 1: Solvency Capital Ratios of STS securitisations vs former Type 1 and Type 2



Source: M&G, EIOPA, as of 1 January 2019. Based on spread risk for securities with five year duration

Designation

Designation of the label is the responsibility of originators, sponsors and issuers but may be outsourced to Third Party Verifiers. TPVs cannot be insurance firms, credit institutions, investment firms or credit rating agencies and cannot provide any advisory, audit or equivalent service to the originator, sponsor or securitisation vehicle involved in the securitisation they assess.

Notifications of eligible STS securitisations are sent to the European Securities and Markets Association (ESMA). Mis-labelled securitisations are liable for sanctions, likely to be fines.

New capital charge rates

Capital charges under the new framework are positive for insurers, with senior STS capital charges now being only marginally higher than for equivalent rated corporate bonds.

The new charges under the STS framework also compare favourably to those of the previous Type 1 / Type 2 securitisations, as Figure 1 illustrates.

Transition rules

Under the new framework, Type 1 securitisations issued prior to 1 January 2019 are still awarded STS status even if the STS requirements are not fulfilled, so long as no new underlying exposures are added or substituted after December 2018.

However, there are qualifying exceptions, which include:

- Type 1 securitisations issued before 18 January 2015 that continue to follow old capital rules;
- Type 1 securitisations with high LTVs on old capital rules until 2025.

Due diligence requirements

In broad terms, the regulations stipulate that prior to holding a position in a securitisation, institutional investors must verify that:

- The originator or original lender has sound underwriting criteria and effective systems in place in order to be able to apply them;
- The originator, sponsor or original lender retains, on an ongoing basis, a material net economic interest in the securitisation that is disclosed to investors;
- The originator or sponsor has made available all required material information under its data transparency requirements on a periodic basis.
- Further, the institutional investor shall also carry out a due diligence assessment considering at least all of the following:
 - The risk characteristics of the individual securitisation position and its underlying exposures;
 - Diligence of all structural features of the securitisation that can materially impact its performance;
 - For STS securitisations, its compliance with the STS requirements must be reviewed.

Once a securitisation position is held investors must monitor on an ongoing basis the performance of the underlying positions and regularly perform cashflow stress tests.

Finally, investors need to demonstrate to their regulator a comprehensive and thorough understanding of the securitisation transaction by implementing all of the above requirements.

Contact

Andrew Swan

+44 (0)20 3977 2166
andrew.swan@mandg.co.uk

John Atkin

+44 (0)20 3977 3718
john.atkin@mandg.co.uk

Henry Barstow

+44 (0)20 3977 3776
henry.barstow@mandg.co.uk

Sunita Dey

+44 (0)20 3977 2428
sunita.dey@mandg.co.uk

Christian Thompson

+44 (0)20 3977 1580
christian.thompson@mandg.co.uk

www.mandg.co.uk/institutions
institutional.clients@mandg.co.uk

For Investment Professionals only.

This document reflects M&G's present opinions reflecting current market conditions. They are subject to change without notice and involve a number of assumptions which may not prove valid. Past performance is not a guide to future performance. The distribution of this document does not constitute an offer or solicitation. It has been written for informational and educational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product. Reference in this document to individual companies is included solely for the purpose of illustration and should not be construed as a recommendation to buy or sell the same. Information given in this document has been obtained from, or based upon, sources believed by us to be reliable and accurate although M&G does not accept liability for the accuracy of the contents.

The services and products provided by M&G Investment Management Limited are available only to investors who come within the category of the Professional Client as defined in the Financial Conduct Authority's Handbook.

M&G Investments is a business name of M&G Investment Management Limited and is used by other companies within the Prudential Group. M&G Investment Management Limited is registered in England and Wales under number 936683 with its registered office at Laurence Pountney Hill, London EC4R 0HH. M&G Investment Management Limited is authorised and regulated by the Financial Conduct Authority. APR 2019 / IM-2607_UK

