The road ahead – practical perspectives on STS and UK auto ABS transactions

In this article we consider some hot topics that are relevant to UK auto ABS transactions seeking STS eligibility.

This article is not intended to be an exhaustive analysis of the requirements for a UK STS securitization, but rather to focus on some perspectives gained from STS applications in the UK ABS auto market. Much of the analysis in this article will also be relevant to equipment financings intending to seek STS treatment.

STS securitizations

The EU Securitization Regulation (Regulation (EU) 2017/2402) (the **Sec Reg**) is a key feature of EU's efforts to establish a capital markets union. It establishes a general framework for securitizations entered into on or after 1 January 2019 and creates a specific framework for simple, transparent and standardised (**STS**) securitizations.

The Sec Reg distinguishes between securitizations which meet the STS criteria and those that do not. A significant advantage of a securitization complying with the STS criteria is the preferential regulatory capital treatment for bank investors and insurers in STS securitizations.

STS securitizations include the following features driven by the Sec Reg:

- Simplicity: Simple transaction structure and homogeneous securitized exposures.
- Transparency: Availability of sufficient information in relation to the securitization.
- Standardization: Comprehensible and comparable securitisation transactions.

The final Guidelines on STS criteria for non ABCP securitizations were published by the EBA on 12 December 2018 and apply from 15 May 2019 (the **Guidelines**).

- Although the Sec Reg has come into force, the other technical standards essential to interpret the Sec Reg are not yet in effect. In particular, the RTS on homogeneity (ensuring STS securitizations include homogenous exposures) has been adopted by the European Commission but has not yet been published in the Official Journal, the RTS on risk retention (applicable to the risk to be retained by the originator, sponsor or original lender) has not been adopted by the European Commission, and the final RTS on reporting (disclosure of information relating to the securitization and the underlying exposures) is subject to approval by the European Commission.

In this article we focus on the following hot topics.

Residual Values (Article 21(13))

Background

Types of finance

In the UK auto finance market, motor vehicle purchases generally take the form of hire purchase agreements (**HP Agreements**) or personal contract plans (**PCP Agreements**) or motor vehicles can be leased from the finance company (**Lease Agreements**). In summary:

- **HP Agreements** involve the amortisation of the entire cost of the vehicle and the cost of financing over a fixed period. At the end of that period title to the vehicle passes from the finance company to the customer. As such residual value risk is taken by the customer.
- **PCP Agreements** are very similar to HP Agreement. The main difference is that at the end of the contract the customer can elect whether or not to purchase the vehicle. As such residual value risk is taken by the finance company (or the investor in the securitization).

- **Leases** can be characterised as either finance or operating leases. In some respects these are similar to PCP Agreements. Title to the vehicle does not pass to the customer under the lease although, particularly with finance leases, customers may have the option to purchase the vehicle. With operating leases this is usually not the case and, often, maintenance services will also be provided to the customer. Residual value risk is taken by the finance company (or the investor in the securitization).

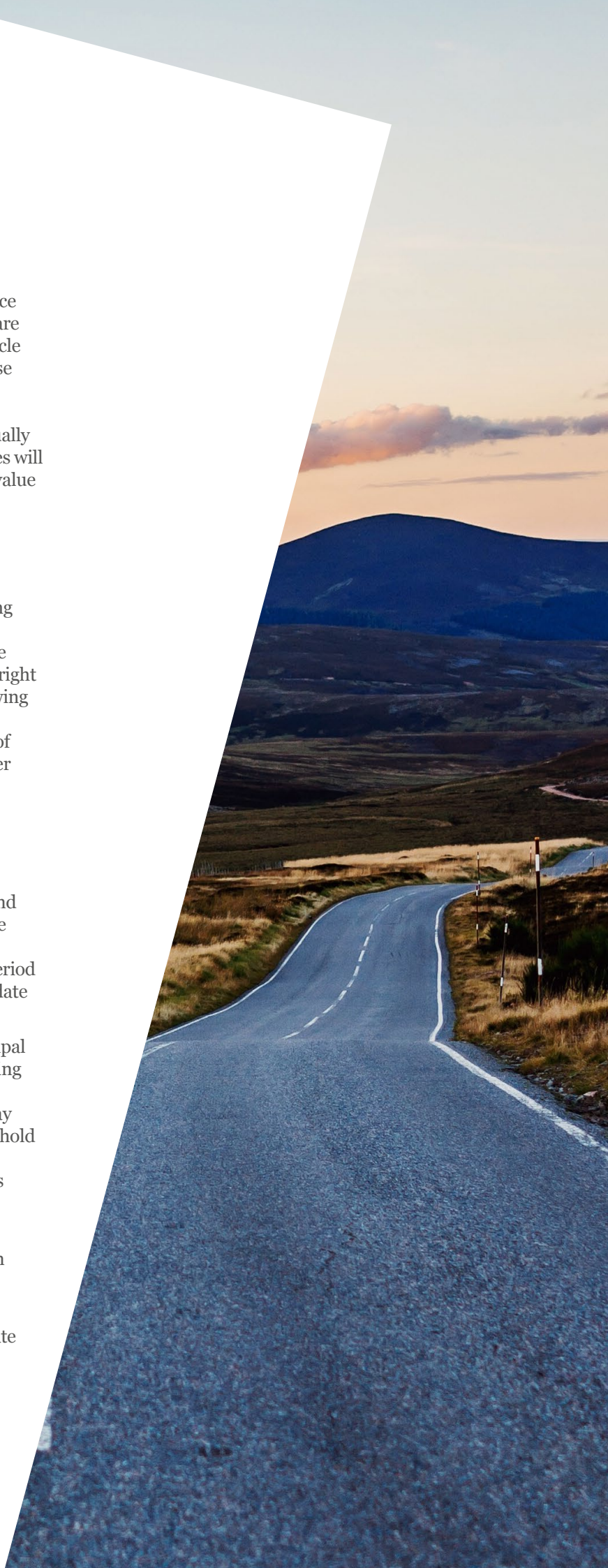
Auto ABS transactions

In UK auto ABS transactions the seller assigns to the SSPE the customer receivable (comprising the payments due by the customer) and may also assign the seller's right to the residual value (the **RV Claim**). The RV Claim represents the right to receive the sale proceeds of the vehicle following (1) its return by the customer at the end of the financing contract or lease or (2) repossession of the vehicle on enforcement against the customer (the element of the receivable relating to the RV Claim being the **RV Exposure**).

Issues

The STS criteria require that the repayment of the securitization cannot be structured to depend predominantly on the sale of assets securing the underlying customer exposures. The final draft Guidelines clarifies that during the revolving period (if a revolving securitization) or on the closing date (if an amortising securitization):

- The contractually agreed outstanding principal balance, at contract maturity of the underlying exposures that depend on the sale of assets securing those underlying exposures to repay the principal balance corresponds to a threshold test of no more than 50% of the total initial exposure value of all securitization positions of the securitization.
- The maturities of the underlying exposures should not subject to material concentration and are sufficiently distributed.
- The aggregate exposure value to a single customer does not exceed 2% of the aggregate exposure value of all underlying exposures in the securitization.



UK perspectives

Sizing the risk

In respect of the STS treatment of UK auto ABS:

- PCP Agreements fall within the scope of the threshold test in Article 20(13) as they contain RV Exposure.
- Regulated HP Agreements and PCP Agreements also fall within the scope of the threshold test in Article 20(13) due to the voluntary termination rights under sections 99 and 100 of the Consumer Credit Act 1974 (as amended). This is a statutory right to terminate the agreement and return the vehicle once the customer has paid more than 50% of the amounts due under the contract without any obligation to pay the remaining balance. This right is exercisable at any time. Voluntary termination rights apply to regulated HP Agreements and regulated PCP Agreements.
- Lease Agreements fall within the scope of the threshold test in Article 20(13) as they contain RV Exposure. Note that in respect of regulated lease agreements, lessees have a right of voluntary termination exercisable at any time but such rights do not apply if the payments in any year exceed £1,500. Regulated lease agreements with payments below this threshold are not generally securitized given the uncertainty as to the potential cashflows.

Identifying the RV Exposure

In terms of ascertaining whether Article 20(13) applies, we suggest:

- **Step 1:** Ensure the outstanding principal balance of all receivables proposed to be included in the portfolio can be identified. Only considering the total contractually agreed outstanding principal balance on maturity and ignoring any embedded interest element.
- **Step 2:** Identify any CCA regulated HP Agreements and PCP Agreements. Note those with corporates, with "high net worth" individuals or individuals entering into the contract for business purposes where the credit is over £25,000 do not need to be included.
  - If any CCA regulated PCP Agreements have a RV Exposure greater than 50% of the principal amount on maturity, this higher amount is relevant for the purposes of the threshold test in Article 20(13).
  - All other regulated PCP Agreements and all regulated HP Agreements have an RV Exposure of 50% of the principal amount on maturity for the purposes of the threshold test in Article 20(13).
- **Step 3:** Identify any non-CCA regulated HP Agreements and PCP Agreements and check for any non-statutory termination rights. Record this RV Exposure for the purposes of the threshold test in Article 20(13).
- **Step 4:** For any non-CCA regulated PCP Agreements record the final balloon for the purposes of the threshold test in Article 20(13).
- **Step 5:** Measure the RV Exposure identified under Steps 2-4 against the principal value of the securitization positions. Note that if Receivables are sold at a discount to face value in order to generate overcollateralisation then, if the discounting includes the principal element, it is more likely the threshold test in Article 20(13) applies.

Mitigating the risk

Even if the RV Exposure exceeds the 50% limit under Article 20(13) all is not lost. Article 20(13) allows for a guarantee or a repurchase agreement from the seller or a third party to be put in place to mitigate the RV risk. This guarantee or repurchase agreement must be in favour of the Issuer.

The guarantee or repurchase agreement would need to apply to the full value of the assets securing the underlying exposures rather than the element which exceeds the threshold test in Article 20(13). This is because Article 20(13) implies that the RV risk must be guaranteed or fully mitigated by a repurchase obligation.

We are also seeing a movement in the market towards including a guarantee or repurchase obligation on transactions where the RV Exposure is below the 50% limit as on transactions where the guarantee or repurchase obligation has been included they are getting better pricing and receiving positive investor feedback.

Changes to notification events (Article 20(5))

Issue

Article 20(5) requires that where a transfer of underlying exposures is perfected at a later stage then the trigger events to perfection should include the three events considered below. These generally depart from the standard list of perfection events on UK automotive securitizations (and, indeed, UK securitizations generally).

It is not clear whether these requirements fully contemplated English law equitable assignments. In most UK (and Irish) securitizations the assignment usually takes effect as a "true sale" in equity as debtors are not notified until a perfection event occurs (whereupon the assignment is converted into a legal assignment).

While the Sec Reg and the Guidelines appear to be targeting an assignment which is perfected (i.e. is effective against the seller) at a later stage, the European Banking Authority's Q&A (the **Q&A**) brings English and Irish assignments firmly into the scope of Article 20(5) and these three events need to be included in the list of perfection events.

UK perspectives

Perfection events should include the following events.

- Insolvency of the seller:
  - This requirement is included as standard in UK transactions to crystallise any set-off rights a debtor may have against the seller.

Severe deterioration in credit quality standing:

- Paragraph 11 of the Guidelines requires the credit quality threshold to be objectively observable and related to the financial health of the seller.
- While there will be an insolvency event trigger included as standard these are unlikely to comprehensively address this criterion.
- Alternatives include an attachment trigger which is a feature of transactions where a floating charge is taken over vehicles in possession of the seller. The rationale for including such an event is that a court would only order an execution on a judgement in a scenario where the seller was under severe cashflow stress. Other alternative perfections events to address Article 20(5) include (if prudentially regulated) a decline in regulatory capital below certain pre-determined thresholds or potentially a form of cross-acceleration as indicative of a failure to satisfy a financial demand.

Unremedied breach of contractual obligations of the seller:

- There is no guidance provided in the Guidelines or the Q&A. Taken literally, this could apply to any breach by the seller whether or not material under any document to which the Seller is a party whether or not such document relates to the transaction.
- We suggest that this requirement should be interpreted purposively, such that it relates to a material breach by the Seller of its obligations under the sale agreement, being the key document for the purposes of the sale.

Servicer experience

Issue

Article 21(8) requires the servicer to have expertise in servicing exposures of a similar nature to those securitised and to have well documented and adequate policies, procedures and risk management controls relating to the servicing of exposures. The first part of this requirement is commonly addressed through the inclusion of a confirmatory statement from the servicer and the second part is addressed through the provision of details as to the servicer's collection and recovery policies in the prospectus. To achieve STS compliance it is not necessary for the policies themselves to be included as part of the transaction documentation or prospectus.

However, the Guidelines expand on this by requiring either:

- the servicer to be an entity subject to prudential and capital regulation and supervision in the Union and such authorisations and permissions to be deemed relevant to the servicing; or
- if the servicer is not subject to prudential and capital regulation, proof of the existence of well-documented and adequate policies and risk management controls, including proof of adherence to good market practices and reporting capabilities and the proof should be substantiated by a third party review, such as by a credit rating agency or external auditor.

UK perspectives

Where the servicer is clearly a Prudential Regulation Authority (**PRA**) regulated entity no further information is required under the Guidelines.
In the UK

However, in the UK the consumer credit and prudential regimes are handled by two different regulators (contrast the position in other European jurisdictions). There is no requirement for a UK auto originator to be prudentially regulated to be a consumer credit lender. Due to the requirement for "proof of good market practices and reporting capabilities" which looks to have been drafted to apply to unregulated entities, UK motor finance originators would fall within paragraph (b) of the Guidelines even if they are long-established.

Practical solutions to meeting this requirement could include the following:

- Obtain an external audit: Many originator-servicers do not have a servicer rating from the rating agencies so cannot easily comply with this requirement. An independent third party, including the verification agent itself, could conduct the audit.
- Ancillary services: Check whether the originator provides any ancillary services (such as insurance broking) which could be prudentially regulated.
- Check statutory audit: The audit opinion confirms that the statements from management provide a true and fair view and will refer to operational risks and regulatory compliance.

Asset Audit (Article 22(2))

Issue

Article 22(2) requires a sample audit of the underlying exposures in addition to a prospectus AUP.

UK perspectives

For the purposes of Article 22(2) this audit will need to be carried out prior to pricing and so the auditors will need to be engaged in good time. This will especially be the case as (unless RMBS transactions) a number of auto-ABS transactions have not typically included an asset audit on a pool sampled basis. For STS the prospectus should contain a statement on the auditor's findings – typically this will be that there are no material adverse findings.

Final thoughts

As more UK auto ABS transactions come to the market the issues encountered in achieving STS compliance should start to harmonise around a set of market standards and common solutions to identified problems. However, this process takes time, effort and resource and as there is as yet no "standard" solution for achieving STS treatment participants should be mindful of allocating sufficient time to work through issues ahead of announcement.

Contacts

Julian Craughan
Partner, London
T +44 20 7296 5814
julian.craughan@hoganlovells.com

David Palmer
Counsel, London
T +44 20 7296 5810
david.palmer@hoganlovells.com