June 2020

IT'S A WONDERFUL WEIGHTED AVERAGE LIFE

EBA final Guidelines on the methodology to determine the weighted average maturity of contractual payments due under the tranche of a securitisation transaction

From the ABS market to your front door

The proper way to calculate the expected date of repayment of an amortising tranche of asset-backed securities (**ABS**) may seem initially to be an abstruse and esoteric topic. But it nevertheless goes to the heart of prudential regulation of the financial system in the European Economic Area (**EEA**). In our recent article https://www.dilloneustace.com/legal-updates/is-synthetic-securitisation-about-to-be-brought-in-from-the-cold on Regulation (EU) No 575/2013 on capital requirements (the **CRR**), Regulation (EU) 2017/2402 (the **Securitisation Regulation**) and Regulation (EU) 2017/2401 amending the CRR (the **CRR Amendments Regulation** and together with the CRR, the **CRR Regs**) as they apply to synthetic securitisation, we alluded to their context as a reaction to the global financial crisis (**GFC**) of 2008. The European Banking Authority (**EBA**)'s final Guidelines on the methodology to determine the weighted average maturity of contractual payments due under the tranche of a securitisation transaction published on 4 May 2020 (the **WAM Guidelines** https://eba.europa.eu/regulation-and-policy/securitisation-and-covered-bonds/guidelines-on-the-determination-of-the-weighted-average-maturity-of-contractual-payments-due-under-the-tranche-of-a-securitisation-transaction), have the same impetus.

From its origins in 14th Century Florence, 'borrowing short to lend long' has been part the calculus of banking business. Because perceived risk of non-payment increases over time, banks are able to exploit differences in the time value of money to profit from the yield margin on cash they lend out over the cost of funds that they borrow. The model can be observed in its simplest form operating at George

For further information on any of the issues discussed in this article please contact:

Conor Keaveny
Partner, Banking & Capital Markets
DD: +353 (0) 1 673 1741
conor.keaveny@dilloneustace.ie

Richard Ambery
Consultant, Banking & Capital Markets
DD: +353 (0) 1 674 1003
Richard.ambery@dilloneustace.ie

Bailey's Building & Loan (**Baileys**) in Frank Capra's 1946 movie, *It's a Wonderful Life*. Here, the citizens of the fictional small town of Bedford Falls can earn a decent yield on their savings by depositing them at Baileys. They and their neighbours can also apply to Baileys for a loan mortgaged over their home to escape the clutches of the town's somewhat unfairly besmirched 'slum landlord', Henry Potter. So much of Baileys' capital has been advanced in what might now be categorised as sub-prime mortgage loans however, that when a crowd of concerned depositors demand the immediate return of their deposits (as they are unquestionably entitled) from an overleveraged Bailey's, George has to tell them that "The money's not there!". All, or certainly too great a proportion of the depositors' cash has been on-lent by Bailey's for periods of twenty years or more so that residents might afford to live in their own home. In order to avoid its bankruptcy, George has to fill Baileys' liquidity gap out of his own funds and rely on the forbearance of depositors.

Despite leaps in time, scale and geography, there is little difference conceptually between Baileys' plight and pre-GFC, structured investment vehicle (**SIV**) conduits issuing one week or month asset-backed commercial paper (**ABCP**) to purchase securities backed by U.S. sub-prime mortgages with legal final maturities of 30 years or more.

Get paid faster

Nevertheless, it would be a gross oversimplification to suggest that securities negotiated on the capital market backed by residential mortgage loans (**RMBS**) redeem lockstep with the pool underlying them according to the terms of each loan on origination. In fact, one imagines that it would be hard to find investors for RMBS that gradually pay off at an uncertain rate over several decades, with the tail end constituting just a few pennies of each dollar originally invested. Accordingly, structurers of RMBS deals apply a priority of payments ('waterfall') to distribute principal and sometimes also revenue receipts from the mortgage pool differently across tranches in order to create separate 'fast-pay' and 'slow-pay' securities. So far so good, but forecasting aggregate principal receipts from a pool of mortgages over any period of time is more art than science.

Most modern mortgage loans are structured so that as far as possible, the borrower makes the same fixed payment each month from the 1st until the 360th. Accordingly for a repayment mortgage, only a tiny proportion of the fixed amount represents principal at the beginning, but nearly all of it on the final repayment date. Naturally in respect of floating rate mortgage loans, the relative proportions of interest and principal (as well as the monthly payment amounts) will change as interest rates move more broadly. Typically, very few residential mortgage loans go to term, redeeming early in accordance with their conditions when the borrower moves home, defaults or dies. The lender obviously has no control over the timing of these events. Last but not least, it is difficult to predict the effects of trends in the wider economy on a particular portfolio of mortgages. For example, an economic recession could lead to a fall in principal receipts reflecting higher delinquencies and / or fewer early redemptions in a subdued property market. Conversely, the level of principal receipts could temporarily increase from a higher foreclosure frequency, depending on recovery levels and periods. Rising interest rates could result in both higher delinquencies of revenue and principal payments among struggling borrowers and a surge in early redemptions as borrowers rush to remortgage with other lenders at more competitive rates.

So what's the WAM?

In order for investors in RMBS and other ABS prudently to manage their respective assets and liabilities, setting aside sufficient reserves of what the CRR Regs refer to as 'own funds' to remedy the kind of liquidity squeeze experienced by Baileys, they make judgments around the securities' expected weighted average maturity, or **WAM**. Specifically, the CRR Regs introduced the maturity of the tranche (M_T) as an additional parameter to calculate the capital requirement of securitisation positions held by regulated entities. The CRR Regs offer two alternative approaches to institutions determining M_T: (i) the WAM of the contractual payments due under the tranche in accordance with Article 257(1)(a); or (ii) the final legal maturity of the tranche in accordance with Article 257(1)(b). Clearly in the case of RMBS that are likely to have a legal final maturity of 25 years or more, the latter approach is likely to prove over-prudential for the reasons stated above, particularly in relation to 'fast-pay' securities. Accordingly, the WAM Guidelines are a vital tool for the proper regulatory accounting for holdings of ABS. More sophisticated accounting for the risk weighted return of ABS investments should also make for their more efficient pricing in the market.

The WAM Guidelines set out unified methodologies for the calculation of WAM as the average amount of time that will elapse from the date of issuance of a security to the date of distribution to the relevant investor of amounts sufficient to fully repay principal in respect of that security, weighted by the principal amortisation on each date for payment of interest. The WAM Guidelines emphasise that calculating WAM combines two elements, namely: (i) aggregated contractual payments of borrowers of loans in the securitised portfolio with calculation based on conditional cash flow assumptions around prepayment, delinquency, default and recovery (**Asset Performance Assumptions**); and (ii) contractual payments payable by the securitisation special purpose entity (**SSPE**) on each tranche of ABS in accordance with its respective priority of payment.

Guidelines for determining WAM

The main areas covered by the WAM Guidelines are:

The meaning of contractual payments due under the relevant tranche of ABS;

- Data and information requirements for application of the WAM approach and adaptations of the principles if certain items of data are missing;
- Differentiated methodologies for determining the contractual payments of the securitised exposures due under a particular tranche in both traditional and synthetic securitisations; and
- Implementation and use of the WAM model, including acceptable Asset Performance Assumptions.

In particular, the WAM Guidelines recognise the different source of cash flows generated within traditional and synthetic securitisations when calculating the WAM of a tranche. Specifically in the case of traditional securitisation, that the contractual payments due in respect of a tranche should be understood as the combination of (i) the contractual payments of the underlying exposures payable to the SSPE and (ii) the contractual payments payable by the SSPE to the tranche holders. In order to calculate these payments, the WAM Guidelines specify how institutions should rely on the asset model introduced by the CRR Regs to calculate the contractual payments due by the borrowers of the underlying exposures, and which inputs should be considered in the CRR Regs' liability model to calculate the contractual payments payable by the SSPE to the holders of each tranche of ABS.

In the case of synthetic securitisations, the WAM Guidelines state that the contractual payments due under the tranche should be understood as the sum of (i) the contractual payments of the premia payable by the originator to the protection provider and (ii) the contractual payments receivable by the originator from the borrowers of the underlying exposures that are allocated to the reduction of the outstanding amount of the tranche, provided that the transaction documentation is clear enough to allow such allocation. Following this interpretation, the WAM Guidelines contain provisions to determine the relative speed of redemption of tranches with and without credit protection. When calculating the rate of amortisation of protected tranches, institutions should account for receipts of premia as well as the allocation of the payments from borrowers to repayment of the tranche, while for unprotected tranches they should include only the latter.

The WAM Guidelines also differentiate between synthetic and traditional securitisations when it comes to the Asset Performance Assumption of prepayment. Under strict conditions set out in Paragraph 32 of the WAM Guidelines, prepayments can be taken into account to reduce the WAM of relevant tranches of traditional securitisations. Conversely, given typically more tailored credit protection terms, prepayments may not be taken into account to determine WAM for synthetic securitisations.

Asset Performance Assumptions in relation to delinquencies and defaults receive more categorical treatment. Paragraph 33 of the WAM Guidelines provides that institutions should assume zero future defaults and delinquencies at the time of the WAM calculation. Paragraphs 40 and 41 deal with recovery rate assumptions in respect of defaults as they arise, depending upon whether the institution is entitled to employ the own-LGD (loss given default) methodology under Part Three, Title II, Chapter 3 of the CRR where 1 *minus* own-LGD applies. Otherwise, with sufficient historical loss data, recovery rates of 1 *minus* 5 year average historical loss rates may be assumed, or the highest historical loss level if data is not available for all of the last five years. If even that data isn't available, recovery rates are assumed to be 50% for senior non-retail ABS and 0% for non-senior non-retail ABS.

Similar rules in Paragraph 41 apply to recovery periods, again depending upon whether the institution is entitled to use the own-LGD approach. Notably, where insufficient historical data is available, recovery is assumed not to occur before legal final maturity.

With regard to optional features in favour of the SSPE or originator to call (redeem) the transaction early, these may not be taken into account for the purposes of calculating WAM under Paragraph 56. However, so-called 'clean-up calls' are excepted under Paragraph 57, where the SSPE has the right to redeem all outstanding securities of a tranche at par if 10% or less of its original principal amount remains outstanding. The position of institutions holding classes of security carrying the right to require the SSPE to put the entire portfolio back to the originator or a designated transferee – an increasingly common feature of European RMBS transactions, is however unclear.

Implementation

The WAM Guidelines apply from 1 September 2020. Under Regulation (EU) No 1093/2010 establishing the EBA, national competent authorities must notify the EBA of compliance, or the regulator will otherwise be assumed to be non-compliant. We nevertheless expect further questions from regulated institutions about their detailed application and related disclosure in ABS offering documents.

Dillon Eustace
June 2020

DILLON EUSTACE

Dublin
33 Sir John Rogerson's Quay, Dublin 2, Ireland. Tel: +353 1 667 0022 Fax: +353 1 667 0042.

Cayman Islands
Landmark Square, West Bay Road, PO Box 775, Grand Cayman KY1-9006, Cayman Islands. Tel: +1 345 949 0022 Fax: +1 345 945 0042.

New York
245 Park Avenue, 39th Floor, New York, NY 10167, U.S.A. Tel: +1 212 792 4166 Fax: +1 212 792 4167.

Tokyo
12th Floor, Yurakucho Itocia Building, 2-7-1 Yurakucho, Chiyoda-ku, Tokyo 100-0006, Japan. Tel: +813 6860 4885 Fax: +813 6860 4501.