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EMERGING A NEW DEDICATED EU REGULATORY REGIME FOR NPL SECURITISATIONS?

As a result of the eurozone economy plunging into historic recession due to the COVID-19 pandemic, a new wave of non-performing loans is expected to hit European banks' balance sheets. This is likely to translate into increased capital requirements and, in turn, will almost certainly affect banks' lending capabilities at a time when they are under pressure to expand as much as possible their credit support, especially to corporates.

In the attempt to support financial markets helping the European Union to recover from the coronavirus crisis, on July 24th the EU Commission issued two proposals of proposed targeted amendments to the capital markets regulatory framework.[1] The EU Commission's package includes, *inter alia*, certain improvements to the securitisation rules, addressing long-standing issues of the current securitisation framework in connection with the regulatory treatment of securitisations of non-performing exposures (the "**NPE Securitisation Proposal**").

The proposed measures are complementary to, and may interplay with, a proposed directive on credit servicers, credit purchasers and the recovery of collateral (the "**Servicers Directive Proposal**")[2] put forward by the European Commission in 2018, which aims to develop the European NPL secondary market by removing certain impediments to cross-border credit servicing and transfer of stocks of non-performing loans. The Servicers Directive Proposal envisages a standardised regulatory regime (definition, authorisation, supervision, conduct rules) for credit servicers, an EU-level framework to ensure uniformity and a passport for carrying out their activities throughout the Single Market.

NPE Securitisation Framework Regulation Proposal: proposed amendments to the Securitisation Regulation[3] and CRR[4]

Based on the recent opinion of the European Banking Authority on the regulatory treatment of non-performing exposure securitisations (the "**NPE Opinion**")[5] and the consultation paper published by the

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[1] See "Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation to help the recovery from the COVID-19 pandemic" (https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1596024242767&uri=CELEX:52020PC0282) and "Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards adjustments to the securitisation framework to support the economic recovery in response to the COVID-19 pandemic" (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020PC0283).

[2] See "Proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral" (https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A52018PC0135).

[3] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32017R2402.

[4] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02013R0575-20200627.

[5] The NPE Opinion, published on 23 October 2019, argue that securitisations can play an instrumental role in reducing NPE stocks in credit institutions' balance sheets, but such a role may be hindered by certain provisions in the EU law securitisation framework. The NPE Opinion recommends various amendments to the Capital Requirements Regulation (CRR) as well as to the Securitisation Regulation to remove the identified constraints.
According to the NPE Opinion, NPE securitisations are transactions backed by pools comprised exclusively or almost exclusively of NPEs at the time of inception. Though structurally similar to other securitisations, the underlying assets have distinctive features that set NPE securitisations apart from those from an economic substance perspective, namely due to the large discount on their nominal value and their specific underlying risks.
The NPE Opinion explains that the regulatory framework imposes certain constraints on credit institutions using securitisation technology to dispose of NPE holdings, namely:

- very high capital requirements on investor credit institutions under the CRR: the pre-eminent securitisation capital methods (the SEC-IRBA and the SEC-SA) and the look-through approach lead to disproportionately high capital charges on NPE securitisation positions when compared to relevant benchmarks and, as a result, tend to overstate the actual risk embedded in the portfolio;
- compliance challenges such as certain risk retention and due diligence requirements under the Securitisation Regulation.

The NPE Opinion recommends that the Commission consider a number of targeted amendments to the CRR and the Securitisation Regulation to remove these constraints whilst maintaining the integrity of the prudential framework.

Basel Committee on Banking Supervision,[6] the NPL Securitisation Proposal contemplates certain amendments to the Securitisation Regulation and the CRR.

Relating to NPE portfolios,[7] the most relevant proposed amendments are:

(a) **A specific definition of NPE securitisation** - Securitisation of non-performing exposures will be defined for regulatory and prudential purposes as the securitisation backed by a pool of non-performing exposures that meet the conditions set out in article 47a(3) of the CRR and the value of which makes up at least 90% of the pool's value at the time of origination;

(b) **Determination of the risk retention** - The risk retention will be based on the 'net value' of the securitised NPEs (*i.e.*, their nominal value or, whether applicable, their outstanding value at the time of the origination, net of the non-refundable purchase price discount (or NRPPD) agreed at the same time). This is a dramatic shift from the rule currently applicable under the Securitisation Regulation, which calculates the retained amount based on the nominal value of the securitised exposures;[8]

(c) **Servicer as risk retainer** – In case of NPE securitisation, the risk retention may be fulfilled by the servicer as an alternative risk retainer to the original lender, originator or sponsor. It is expected that the definition of 'servicer' under the Securitisation Regulation will be harmonised with that of 'credit servicer' under the Servicers Directive Proposal, once the latter is adopted;

(d) **Exception to the credit-granting standards requirement** – The credit-granting standards requirement set out in article 9 of the Securitisation Regulation will not apply to underlying exposures that are non-performing exposures as referred to in the CRR at the time they were purchased by the originator from the relevant third party. According to the EU Commission itself, this is because "[i]n these cases, it may not be possible to gain certainty around the circumstances in which the assets were created". Given the generality of the exemption, it would probably apply irrespective of whom (sponsor, originator or servicer) will be acting as risk retainer;[9]

(e) **Risk weight of NPL securitisations** - For the purposes of regulatory capital treatment:

 (i) senior tranches of traditional NPE securitisations with a NRPPD equal to or above 50% (so-called 'qualifying' NPE securitisations) will be subject to a flat 100% risk weight (irrespective of their thickness of the relevant tranche);

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[6] https://www.bis.org/bcbs/publ/d504.htm.

[7] The EU Commission's proposal will complement the current securitisation framework set out in the Securitisation Regulation and the CRR in two targeted areas. In addition to removing regulatory obstacles to the securitisation of NPEs, the amendments would extend the STS framework to on-balance-sheet synthetic securitisation. The extension of the STS framework would be granted to on-balance-sheet synthetic securitisations (*i.e.*, securitisations where the originator continues to own the underlying exposures) structured to work as a risk management tool for bank lending to corporates, in particular SMEs. On-balance-sheet synthetic securitisation differs from other synthetic securitisations where the originator, instead of hedging credit risk, seeks to benefit from arbitrage opportunities in the pricing of different tranches of credit portfolios (the latter are called "arbitrage" synthetic securitisations which played an infamous role in exacerbating the global financial crisis and will not qualify for the simple, transparent and standardised label).

[8] In the case of NPE securitisations, using nominal values for risk retention purposes has proved to be inconsistent with the economics of the underlying transaction and, therefore, the EBA has recommended to allow calculating the risk retention amount after applying the non-refundable purchase price deduction.

[9] The purpose of the requirement is to protect against the risks of asymmetric information producing an "originate to distribute" model whereby assets of inferior quality are selected for securitisation to the detriment of investors, who would end up with more risk then they might have intended to take. While the overarching principle remains appropriate for NPL securitisations, "the requirements have to take into account the specific circumstances of the purchase of the assets and the type of securitisation" (see recital (7) of the proposed Regulation of the European Parliament and of the Council amending Regulation (EU) 2017/2402).

(ii) all other exposures to NPE securitisations (whether 'qualifying' or not) will be subject to the usual securitisation framework subject to a general 100% risk weight floor and a ban on the use of Foundation IRB parameters in the SEC-IRBA.

Final Remarks

The timing of the new EU Commission proposal is indicative of the view that NPL securitisations are likely to increase in a post-pandemic global economy. In anticipation of this, the above-listed measures are expected to build cohesion in the EU securitisation framework. For industry participants, these measures will better reflect the true risks associated with securitisation of NPLs and thereby make NPL securitisations a more efficient tool for institutions to better manage this growing sector of the loans market.

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