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Commentary

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European Commission Proposes Amended Framework for the Securitisation of Non-Performing Exposures

The proposal is part of an effort to aid economic recovery and enhance the capacity of banks to lend to corporates and SMEs.

The European Commission's proposal to amend the Securitisation Regulation[1] and the Capital Requirements Regulation (the CRR)[2] comprise part of its Capital Markets Recovery Package to help mitigate the economic effects of the coronavirus pandemic. Although the EU regulatory framework for securitisations is due for a comprehensive review with possible legislative amendments by January 2022, in July 2020 the Commission brought forward certain targeted amendments, in an effort to aid economic recovery and enhance the capacity of banks to lend to corporates and, in particular, small and medium-size enterprises (SMEs). If adopted, these amendments (summarised in detail below) will have direct effect without the need for implementation by Member States at the national level.

The securitisation of non-performing exposures (NPEs) is one of the focus areas of the Commission's proposed amendments. The amendments proposed in relation to NPEs reflect the findings of the European Banking Authority (EBA) in its October 2019 opinion, which examined the role of securitisation as a funding tool for removing NPEs from the balance sheet of banks. In its opinion, the EBA reported a number of constraints in the Securitisation Regulation and in the CRR. Those constraints had the effect of restricting the capacity of market participants to acquire NPEs from banks, meaning that bank de-leveraging was occurring at a slower pace than was expected, as disposals were largely on a bilateral sale basis.

Notably, the Commission's proposed amendments to address the shortcomings identified by the EBA relate only to matters contained in the Securitisation Regulation and therefore do not address the concerns expressed by the EBA in relation to what it described as the seemingly disproportionate capital charges applicable to holdings of NPE securitisations under the CRR when compared to relevant benchmarks.

Changes to Article 2 Definitions

A new point (24) is to be added to define a "non-performing exposure securitisation" to mean "a securitisation backed by a pool of non-performing exposures that meet the conditions set out in Article 47a(3) of Regulation 575/2013 and the value of which makes up at least 90% of the pool's value at the time of origination".

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This definition is aligned with the approach of the Basel Committee on Banking Supervision (BCBS) to reforming the capital framework for NPEs, and recognises that any portfolio brought to market may include:

- A percentage of loans that are performing or were once non-performing but are now re-performing
- Loans that have yet to default but are expected to default at their maturity

However, some industry participants remain concerned that the Commission, by drafting the definition as a minimum requirement in terms of percentage without a ceiling, intends to allow Member States to require an even greater percentage of exposures to be non-performing when classifying a securitisation as being backed by NPEs for regulatory capital purposes. In addition, the definition is unclear when the percentage of NPEs should be measured, i.e., the pool cut-off date or the transaction closing date, and whether the percentage should be retested each time assets are added to or removed from the pool.

A Special Article 6 Risk Retention Regime for NPEs

The Commission intends to subject NPE securitisations to a special regime when it comes to fulfilling the risk retention requirement, given the special characteristics of NPEs. Article 6 of the Securitisation Regulation requires the risk retention amount to be calculated using the nominal value of the NPEs, which results in an overstated amount and disregards the actual risk of loss to investors. The Commission therefore proposes that the amount required to be retained is calculated on the basis of the net value of the securitised exposures that qualify as non-performing exposures. The net value is determined by deducting the non-refundable purchase price discount agreed at the time of origination from the exposure's nominal value or, if applicable, its outstanding value at the time of origination.

The proposed amendments to Article 6 also purport to extend the universe of entities eligible to fulfil the risk retention requirement beyond the originator, sponsor, and original lender to allow for retention by the special servicer appointed to work out the NPEs. This change recognises that a special servicer's interests are more aligned with the investors, as the special servicer would typically have a more substantive interest than the originator in the work-out and recovery of the NPEs, especially if the special servicer retains the mezzanine and/or junior tranche and its fees are paid out of the securitisation waterfall. In contrast, originators (in the traditional sense of the originator also being the original lender) would typically seek a clean break from the assets being transferred. This difference is important, given that a stated intention behind the proposal is to free up banks' balance sheets to facilitate increased lending to corporates and, in particular, SMEs.

A New Exemption to the Article 9 Credit-Granting Criteria Requirement

The rationale behind the Article 9 Securitisation Regulation credit-granting requirements was to address the perceived misalignment of interests in the "originate to distribute" model prevalent before the 2008 financial crisis, when assets of inferior quality were selected for securitisation, resulting in investors acquiring greater risk than they may have intended to assume.

By requiring originators to verify the credit-granting standards used in the origination of securitised assets, Article 9 is intended to preclude such discriminatory practices from occurring. However, the Commission recognises that, in the case of NPEs, the verification process should take into account the specific circumstances of NPE securitisations (by virtue of being non-performing, such assets are already credit impaired) so that investors can conduct appropriate due diligence on the quality and performance of the NPEs in order to make a sensible and well-informed investment decision. Accordingly, the Commission is

proposing that the requirements set out in Article 9(1) of the Securitisation Regulation should not apply to underlying exposures that are NPEs according to Article 47a(3) CRR at the time the originator purchased them from the relevant third party.

Conclusion

Whilst the Commission's objectives are to be welcomed, whether amending the Securitisation Regulation alone will facilitate the greater use of securitisation by banks to free their balance sheets of NPEs (with the added benefit of lower funding and transaction costs and lower losses for the originating institution) remains to be seen. The CRR may also need to be amended, in order to level up the playing field in terms of regulatory capital treatment of NPE securitisations. The BCBS published in June 2020 a draft technical amendment (draft TA) to its framework for comment entitled "Capital treatment of securitisations of non-performing loans" in which the BCBS acknowledged the need to address "the potential mis-calibration of risk weights applicable" in this context. However, the draft TA does not follow the recommendations of the EBA for re-calibrating the credit risk and external ratings formulae for risk weights and instead proposes the imposition of fixed risk weights (e.g., 100%, regardless of credit rating) together with a requirement for a high non-refundable purchase price discount of at least 50% in order to qualify for such 100% risk weight (otherwise a 100% risk-weight floor will apply).

Unless the draft TA is amended, it may be more difficult to resolve NPEs on a cost-effective basis through the use of securitisation. Banks may be less inclined to invest if the capital required to do so is disproportionately high compared with the ratings applicable to those countries and securitisations where achieving strong investment grade credit ratings on the senior tranches is possible. The risk, then, is that without a recalibration of the risk weights more in line with the recommendation of the EBA in its October 2019 opinion, the Commission's proposed amendments to the Securitisation Regulation will largely be of token benefit, and households and businesses will not have access to bank capital of the scale needed to fund the economic recovery required following the current crisis.

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Endnotes

[1] Regulation (EU) 2017/2402.

[2] Regulation (EU) 575/2013.