Position Paper: COM proposals on securitisation of NPEs to help the recovery from the Covid-19 pandemic

September 2020

Introduction

The summer 2020 economic forecast of the European Commission (the "Commission") points to a very deep recession as economic activity collapsed in the first half of 2020 and real GDP for 2020 as a whole in the EU is projected to decline by 8.3%. Targeted measures are therefore required to support a speedy recovery, and it will remain key for banks to be able to continue lending to corporates and households in the coming months once the immediate shock of the Covid-19 crisis will have passed.

It is therefore likely that the amount of non-performing exposures ("NPEs") in the EU will increase in the coming months. Excessive amounts of NPEs act as a heavy burden on bank balance sheets: they consume regulatory capital and management time and reduce future capacity to lend. It is therefore essential that "tools allowing banks to maintain and even enhance their capacity to lend to the real economy" - and specifically to enable swift and effective resolution of NPE portfolios - are prepared or upgraded.

Accordingly, in July 2020 the Commission published legislative proposals to amend Regulation (EU) 2017/2402 (the "Securitisation Regulation" or "SR") and Regulation (EU) 575/2013 (the "Capital Requirements Regulation" or "CRR") to make certain targeted adjustments to the existing framework to enable securitisation in the EU to be used "in the most efficient manner to promote the economic recovery in the coming months".

The scope of the proposals encompassed both (1) a new framework for "simple transparent and standardised" or "STS" securitisation for on-balance-sheet synthetic securitisation (the subject of a separate AFME Position Paper); and (2) adjustments to address the fact that the current securitisation framework "is not entirely fit for purpose for the securitisation of NPEs" (the subject of this Position Paper).

The proposals to enhance the role of securitisation as a funding tool for removing NPEs from the balance sheets of banks fall into two categories: amendments to the Securitisation Regulation and amendments to the CRR.

Summary of AFME's position

Amendments to the Securitisation Regulation

AFME broadly supports the proposed amendments to the Securitisation Regulation (the "SR NPE Amendments") to facilitate easier NPE securitisation, subject to our comments below.

Amendments to the CRR

Regarding the proposed amendments to the CRR (the "CRR NPE Amendments"), these implement proposals made in June 2020 by the Basel Committee on Banking Supervision (the "BCBS") in their Technical Amendment on "Capital treatment of securitisations of non-performing loans" (the "TA"). The TA was issued for consultation until 23rd August 2020.

AFME and other trade associations responded in detail here (the "Joint Trades' Response to the TA").

While we supported some aspects of the TA, we also expressed significant concerns many of which are equally applicable to the CRR NPE Amendments. These are set out in more detail below.

Specifically, the risk weight floor of 100% and the fixed risk weight for senior tranches will bring about higher risk weights than currently apply, leading to greater divergence between risk and regulatory capital, an unlevel playing field (especially across the EU, where the revised Basel securitisation framework has been adopted) a greater (not lesser) dependence on the bank/sovereign nexus and less risk-sensitivity in the framework. These results will hinder, rather than encourage, the use of securitisation in resolving NPE challenges for EU banks.

For an illustration of the impact of the fixed risk weight of 100% on existing and future transactions see Appendix 1.

A well-functioning securitisation framework is key for resolving NPEs

The Commission's proposals for NPEs already acknowledge this, but by way of summary we list here the many benefits securitisation can provide in resolving stocks of NPEs:

- attracts a wider investor base, so delivering incremental funding;
- helps address the bid-offer gap in pricing NPE portfolio disposals;
- available in large volumes, if appropriately targeted;
- improvement of capital ratios (after write-offs);
- true sale from the balance sheet demonstrating a "clean break";
- flexibility for the seller around which part of the risk is transferred to the investor and which retained (subject to risk retention rules); and
- additional, external third-party scrutiny and credit analysis.

A well-functioning framework for NPE securitisation can therefore do much to support resolution of banks' NPE challenges, which are expected to be further exacerbated by the Covid-19 pandemic and related economic deterioration. Banks are major investors in the senior tranches of NPE securitisations. Therefore, effective rules under the Securitisation Regulation as well as well-calibrated risk-weight rules under the CRR are crucial to a functioning, efficient, prudent and cost-effective market for NPE securitisation.

The SR NPE Amendments

Article 2 SR: definition of NPE

The definition of NPE securitisation is unclear as to when and how the level of NPEs included in the transaction should be measured. We therefore suggest an amendment which would make it clear that "NPE securitisation" means a securitisation backed by a pool at least 90% by nominal value of which is composed of non-performing exposures. The Commission proposal for the definition is also unclear as to timing of measurement. We seek to clarify here that this should be measured at the cut-off date for the origination of the securitisation but also re-tested at any time when assets are added to or removed from the pool. This brings the definition into line with that proposed in the TA.

Furthermore, we would like to stress the point made in the Joint Trades' Response to the TA where we argued that the TA should not permit national supervisors to impose a stricter definition of "NPE securitisations" than at BCBS level. So the EU definition (and definitions in other regions) should align with the TA definition, assuming it is adjusted as we have requested.

In the Joint Trades' Response to the TA we also pointed out that "the TA definition should not allow for flexibility unless there are legal impediments in a specific jurisdiction preventing performing and non-performing exposures to form part of a single securitised pool. Flexibility in the definition will lead to inconsistent application globally, implementation complexity for internationally active banks and potentially promote competitive advantages for certain institutions".

Article 6 SR: risk retention

We support the amendment to allow risk retention requirements to be fulfilled by the servicer.

We support the amendment to allow the retention of a material net economic interest of not less than 5% of the net value of the securitised exposures that qualify as non-performing exposures following deduction of the NRPPD agreed at the time of origination from the exposure's nominal value or its outstanding value at the same time.

Article 9: criteria for credit granting

We support the disapplication of Article 9(1) to underlying exposures that are non-performing exposures.

The CRR NPE Amendments

The 100% floor for a position in an NPE securitisation

AFME strongly opposes this proposal. It is the same proposal as in the TA where no justification has been offered for it. Indeed, it is difficult to see what a justification could be. Further, it would appear to achieve the opposite of the stated aim of the CRR NPE Amendments to address "excessive capital requirements … particularly under SEC-IRBA and SEC-SA. Nor does it encourage risk-sensitivity in risk weighting because it is not correlated with the real risk profile of the relevant tranche.

In respect of the SEC-ERBA, there is no reason to give more or less weight to a rating for a securitisation of NPEs than for a securitisation of performing loans. SEC-ERBA would, for example, produce a 65% risk weight for an A-rated senior tranche of a non-performing portfolio (which, even assuming implementation as proposed, could be achieved by keeping the proportion of the pool that is NPEs just under 90% - which is surely a perverse result). This is just one example of many where a strong case can be made for a risk weight lower than 100%. Similar considerations apply under advanced IRB and SEC-SA in the case of unrated transactions.

The imposition of a 100% risk weight floor also seems to be overly conservative, as it would mean that a senior tranche of an NPE securitisation would frequently have the same risk weight as the underlying assets despite the securitisation structure adding significant liquidity and credit enhancement. Rather than encourage the securitisation of NPEs, this would discourage it. It should also be noted that for NPE securitisations where the senior tranche principal is repaid first, this allows the deleveraging of the securitisation and would normally improve the credit rating of the senior tranche over time. A 100% risk weight floor would remove this recognition of improved credit quality from the regulatory capital framework and reduce secondary market appetite for bank investors.

Instead, we urge that the floors remain as they are today for securitisations of performing loans, given that the various approaches already aim to be risk-sensitive, prudent and take account of potential modelling difficulties.

Fixed risk weight of 100% for the senior tranche

This proposal is contrary to the stated aim of making the risk weighting of NPE securitisations risk-sensitive. Some NPE securitisations have risk profiles for which 100% would be disproportionately high as a risk-weight for the senior tranche. Where, for example, the NPEs securitised are predominantly residential or commercial mortgages, the risk weight of the senior tranche may be much lower owing to the appraised market value of the collateral securing the underlying loans. To enable a healthy NPE market to develop, a more risk-sensitive approach should be adopted.

We recommend instead using 100% as a ceiling for senior tranches of NPE securitisations, rather than as a fixed risk weight. This is on the basis of the look-through approach already applied to securitisations. That is to say, banks are already permitted to limit the risk weight of a senior tranche in a securitisation to the risk weight of the underlying assets. For defaulted assets in respect of which a write-down of at least 20% has already been taken, the risk weight of the underlying assets would be 100%. It therefore makes sense to say that, where a pool of defaulted assets has been sold into a securitisation with a NRPPD of at least 20% (rather than the 50% currently suggested as a minimum standard for "qualifying" NPE securitisations), in proposed Article 269a(2)), the senior tranche should never be risk weighted at more than 100%. This amounts to an administrative adaptation of a principle already acknowledged by BCBS to be sound. Instead of requiring the 20% write-down to be taken at the asset level, it would be permitted to be taken in the form of a (minimum) 20% NRPPD at the transaction level. Of course, if the applicable capital calculation methodology permits a

lower risk weight (e.g. a senior tranche of an NPE securitisation being weighted at 65% under SEC-ERBA because it achieves an A rating) then that should be permitted because the purpose of the ceiling is to avoid the securitisation capital methodology (which is designed to be conservative) being overly conservative and losing risk-sensitivity.

EU authorities should therefore encourage BCBS to pursue the re-calibration of the SEC-IRBA and SEC-SA formulae proposed within the EBA's opinion as outlined in the Joint Trades' Response to the TA.

Separately, we note that we can see no reason why this should not apply to on-balance-sheet or "synthetic" securitisations – provided that our alternative approach is adopted. Such securitisations are also a valid method for banks to offload the risk of NPEs and the securitisation framework applies equally to them. No justification has been offered for why they should be excluded from a more beneficial NPE securitisation capital regime and none is obvious to us.

Prohibition of use of supervisory estimates of LGD and conversion factors

We support this amendment, since foundation IRB involves modelling only PD, and using fixed regulatory inputs for EAD and LGD. Since an NPE securitisation will by definition involve a high proportion of defaulted assets (which will have a PD of 1), no model can be used at all.

That said, we would emphasise that the same considerations do not apply in respect of advanced IRB, which should remain available for use by banks where authorised by their respective prudential regulators.

Inclusion of expected losses after deduction of NRPPD and SCRA

We support this amendment. Additionally, the full net basis calculation as proposed by the EBA's opinion should be made available for the most senior tranche of NPE securitisations. This means both the expected losses and exposure value referred to in Article 267(3) should be net by the amount of the relevant NPE's NRPPD and, in the case of the originator, any additional specific credit risk adjustments.

Conclusion

We support the SR NPE Amendments, subject to our comments above .

While we support some of the CRR NPE Amendments, we have significant concerns that the proposals for the risk weight floor of 100% and the fixed risk weight for senior tranches could bring about higher risk weights than currently apply, leading both to greater divergence between risk and regulatory capital, an unlevel playing field across the EU, greater not less dependence on the bank/sovereign nexus and less risk-sensitivity in the framework. Such developments will discourage, rather than encourage, the growth of securitisation as a tool to help resolve the challenges of NPEs on the balance sheets of EU banks.

We appreciate that in principle the Commission typically wishes to align its proposals with those of the BCBS. It is disappointing that the BCBS did not take forward the work of re-calibrating the SEC-IRBA and SEC-SA formulae through following more closely the proposals set out in the Opinion of the European Banking Authority ("EBA") of October 2019 (the "EBA Opinion"), including adjustments to the *p*-factor and allowing risk parameter inputs on a net basis.

Particularly given the economic outlook, we urge the Commission to urge the BCBS to re-assess its approach in line with the re-calibration work proposed by the EBA Opinion in relation to the SEC-IRBA and SEC-SA formula functions, and ratify the clarification provided which currently allows for the recognition of NRPPD or SCRA in determining the maximum risk weight for the senior tranche and maximum risk weighted assets for the securitisation positions held as proposed by the EBA Opinion for SEC-IRBA, SEC-SA and SEC-ERBA.

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Appendix 1 – illustration of the impact of the fixed risk weight of 100% on existing and future transactions

The proposal for a fixed risk weight of 100% if the NRPPD is at least equal to 50%, otherwise a 100% RW floor, makes it much more difficult to achieve cost-effective resolution of NPE portfolios because it increases materially the capital required to be held by bank investors, who often use the SEC-ERBA approach for rated senior notes.

This is unhelpful to market development for a number of reasons.

First the retention by the disposing bank of senior tranches of NPE securitisations is key to their execution, especially of offloading the riskier low-rated or non-rated tranches.

Second, the higher capital required will create particular difficulties for those countries, and/or securitisations secured by collateral of reasonable quality, where it is possible to achieve a relatively high rating of A/BBB for the senior tranche, resulting in a risk weight under SEC-ERBA of less than 100%, and sometimes also for those institutions which use the Advanced IRBA under the SEC-IRBA methodology. Some examples are set out below.

Some examples of rated NPE transactions with implied risk weight below 100% (assuming 5 years tranche maturity)

Popolare Bari NPEs 2016 S.r.l	Baa1	90%
Prisma SPV S.r.l.	Baa1	90%
Spring SPV S.r.l.	Baa1	90%
FINO 1 Securitisation S.r.l.	A2	65%
European RLS 2019-NPE2 DAC	A2	65%
Siena NPE 2018	Baa1	90%
Grand Canal Securities 2-2017	A2	65%

A fuller list of Italian NPE transactions can be found in *BofA Global Research European SF Weekly of 6th July 2020 (Batchvarov and others)* available here.

The QIS, and the impact of Italian NPE securitisations on the data

We understand that a QIS was undertaken prior to the development of the TA. We have not seen it. We therefore wonder how wide-ranging the data may be, and if it has been correctly interpreted.

For example, Italy has a low sovereign rating plus a long and difficult enforcement process. This tends to make it challenging to achieve better ratings in Italian NPEs. Indeed, many Italian NPE securitisations are structured to Baa3 (140% risk weight) because this is the minimum rating required to qualify for the GACS scheme. The GACS scheme delivers a risk weight of 0%.

We do not know whether the QIS took into account Italian transactions assuming a pre-GACS or a post-GACS risk weight. If the former, then this may be why the proposal in the TA of a 100% risk weight floor may have seemed reasonable (if the market seemed dominated by transactions with risk weights above 100%). It is also not clear whether such QIS would have had access to the private securitisation market and whether data had been collected from such bilateral / private securitisations (e.g. where institutions currently use the SEC-IRBA methodology).

Future evolution of NPEs across the EU, ex-Italy

Low sovereign ratings, and the slow enforcement aspects of Italian NPE securitisation, are not always found in other European countries. It is therefore reasonable to expect more NPE securitisations in the A/A2 range (65% risk weight), or potentially even a little higher.

Data collected from private NPE securitisations undertaken in the EU ex-Italy may lead to better understanding of recoveries including possible divergence of recoveries between different member states, as well as more broadly across different regions internationally.

Incentives will be created to change transaction structures

If the proposed fixed risk weight of 100% is adopted, incentives will be created to change market structures which could include:

- greater reliance on sovereign guarantees (similar to GACS in Italy or HAPS in Greece) to achieve a 0% risk weight and avoid the application of the fixed 100% risk weight, increasing the bank / sovereign nexus;
- encouraging a decline in credit quality of senior-most tranches - in the BB to low-BBB range for eligible pools or high BBB range (BBB to BBB+) for non-eligible pools (if a guarantee cannot be found); and
- excluding certain asset classes such as SME loans and residential mortgages which can make higher rated senior tranches (high BBBs to single As) achievable.

All of the above effects would hinder, rather than encourage, the use of securitisation in resolving NPE challenges for EU banks.