

## EBA PUBLISHES OPINION ON REGULATORY TREATMENT OF NPE SECURITISATIONS

Over the past several years, there has been an increasing focus at the European level on measures that might be taken to help facilitate the removal of non-performing exposures ("NPEs") from bank balance sheets. On 23 October, the European Banking Authority ("EBA") made a substantial contribution by publishing an opinion<sup>1</sup> (the "EBA Opinion") suggesting adjustments to the regulatory regime for NPE securitisations. These include recommendations for adjusted regulatory capital treatment, risk retention and diligence obligations. These adjustments are designed to apply only to NPE securitisations and make them more fit for the particular circumstances that apply when securitising NPEs.

### Background

The financial crisis and economic recession of 2008 to 2009 left EU credit institutions holding large amounts of NPEs. Many of these NPEs remain on bank balance sheets today, tying up large amounts of regulatory capital and inhibiting European banks' return to healthy growth and their ability to lend to the real economy. Despite enthusiasm in the official sector for the idea of using securitisation as a tool to help reduce stocks of NPEs on bank balance sheets, the rate at which this has been happening has been slower than many policymakers and market participants had been hoping. The EBA Opinion is set against the backdrop of the Council of the European Union's acknowledgment that there are legal "impediments to the transfer of NPEs by banks to non-banks and their ownership by non-banks" in its *Action plan to tackle non-performing loans in Europe*<sup>2</sup>.

In its opinion, the EBA identifies impediments to the securitisation of NPEs<sup>3</sup> under the Capital Requirements Regulation (the "CRR") and Securitisation Regulation, in particular. While the suggestions in general are aimed solely at NPE securitisations, the EBA does also acknowledge the need for a definition

### Key issues

The EBA Opinion contains suggestions to:

- adjust capital requirements for NPE securitisations under SEC-IRBA and SEC-SA to be more risk-sensitive and better aligned with the outcomes under SEC-ERBA
- take a "full net" approach to recognising non-refundable purchase price discounts when calculating securitisation capital caps
- add the independent servicer as an eligible retainer for NPE securitisations
- recognise the acquisition price when calculating size of risk retention for NPE securitisations
- recognise and mitigate the legitimate compliance difficulties often associated with Article 9(3) of the Securitisation Regulation

<sup>1</sup> <https://eba.europa.eu/eba-publishes-opinion-regulatory-treatment-non-performing-exposure-securitisations>

<sup>2</sup> <https://www.consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans/>

<sup>3</sup> The EBA Opinion, we note, examines the regulatory impediments to the securitisation of NPEs without actually examining the sometimes finely balanced question of whether a particular NPE financing is, in fact, a securitisation. For the moment, therefore, the EBA Opinion should not be read as affecting that analysis one way or the other.

of "NPE securitisation" and that a method of applying at least some of the suggestions to securitisations of mixed (NPE and performing) pools will be needed.

## **CRR adjustments**

In respect of the CRR, the EBA Opinion finds that both the SEC-IRBA and the SEC-SA approaches tend to produce disproportionately high capital charges for NPE securitisations (although the foundation SEC-IRBA can have the opposite effect, especially at mezzanine and junior levels of the capital structure). The EBA uses the SEC-ERBA as a benchmark for comparison "because the credit rating process pays better regard to the preeminent NPE securitisation risk drivers".

The EBA Opinion also finds that the caps for securitisation capital weightings (based on the capital charges that would apply to the underlying assets) as currently set out in the CRR produce inappropriately high results, and therefore fail to serve their main purpose: as a safeguard against the overly conservative capital charges that may result from the securitisation methods of capital calculation.

Many of the miscalibrations the EBA Opinion describes result from the failure of the regulatory framework to appropriately take account of the loss-absorbing effect of the non-refundable purchase price discount (or "**NRPPD**") that tends to characterise NPE securitisations. It also points out that the non-neutrality factor or "p" factor is calibrated to deal with securitisation of performing exposures, and also leads to inappropriately high capital charges for NPE securitisations even when set at its floor levels (0.3 for the SEC-IRBA and 1 for SEC-SA).

The EBA Opinion recommends that the Commission examine the possibility of making targeted amendments to the level 1 text of the CRR in order to address these issues, including setting a more appropriate level of the "p" factor for NPE securitisations and taking account of the NRPPD both by taking a net book value approach to the inputs for the formulaic approaches (SEC-IRBA and SEC-SA) and by taking a full net approach to calculating the levels of caps for NPE securitisation capital charges.

## **Securitisation Regulation Adjustments**

In relation to the Securitisation Regulation, the EBA Opinion makes three broad suggestions:

- **Independent servicers as risk retainers:** The first suggestion is that the eligible holders of risk retention ought to be extended to include the independent servicer of an NPE portfolio, provided that its interests in the successful workout of the assets are appropriately aligned with those of the investors. This is a reflection of the fact that NPE portfolios are often serviced by an independent servicer whose compensation is paid out of the collections from the assets and may even retain the mezzanine or junior tranche. In such cases, the servicer will often not meet the definition of a sponsor (for lack of an appropriate EU regulatory status) but may nonetheless be the most aligned and hence logical person to have as retainer. After all, in the context of an a pool of assets that are by definition non-performing, guarding against "originate to distribute" is no longer the primary concern. Rather, aligning the interests of the investors with the

entity most able to influence the success of the workout of the assets is the more appropriate regulatory goal.

- **Adjusted methodologies for calculating risk retention amounts:** This suggestion seeks to address the inappropriate outcomes generated as a result of the fact that most of the permitted risk retention methods calculate risk retention amounts based on the nominal value of the underlying assets. For the moment, this "nominal value" does not take account of acquisition price. By way of example, where the assets are sold into the securitisation with a 90% NRPPD – not unrealistic for an NPE securitisation – a retention of 5% of nominal value of the assets would result in having a retention piece equivalent to 50% of the acquisition price of the portfolio. Accordingly, the EBA Opinion recommends amending the risk retention rules as they apply to NPE securitisations such that parties would be permitted to take account of the NRPPD when calculating the nominal value of assets for the purposes of determining the size of the retention piece. In the example of a 90% NRPPD, that would result in a retention piece of 5% of the acquisition price, or 0.5% of the (gross) nominal value of the assets.
- **Verification of origination standards:** The final suggestion in the EBA Opinion aims to recognise the difficulties of applying the requirements under Article 9(3) of the Securitisation Regulation, which requires originators to verify the application of "the same sound and well-defined criteria for credit-granting" to the securitised assets as were applied to non-securitised exposures. In this respect, the EBA merely points out the a range of legitimate reasons why there may be compliance difficulties caused by Article 9(3) and suggests "a specific treatment for NPE securitisations and certain other securitisations with third party originated assets"<sup>4</sup>.

## A step forward

The EBA Opinion represents a useful recognition of the legal obstacles to NPE securitisation and contains a series of helpful recommendations for alleviating them. It is now up to the Commission to decide how (and whether) to progress the recommendations. Even if the Commission proceeds immediately, however, it could be some time before the recommendations are put into place – particularly as most suggest amendments to the level 1 text.

Finally, we note that there are a number of other areas under the Securitisation Regulation where the nature of NPEs and NPE securitisations present difficulties for compliance. Of these, perhaps the most notable is compliance with the transparency and disclosure requirements. These, of course, are not the province of the EBA but rather that of the European Securities and Markets Authority. While we are not aware of ESMA undertaking equivalent work to the EBA, recommendations from ESMA designed to facilitate NPE securitisations would no doubt be welcomed by market participants.

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<sup>4</sup> It is worth noting that this comment from the EBA underlines that the EBA recognises issues complying with Article 9(3) for securitisations of legacy asset portfolios and not just NPEs. See, for another example, the recent EBA Q&A regarding Article 9(3), available here: [https://eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2018\\_4368](https://eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2018_4368)

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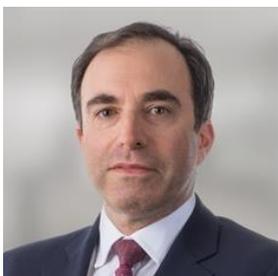
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