NPEs securitisation framework

Follow up on EBA opinion

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NPEs securitisations regulatory treatment

On October 23rd, the EBA released an opinion on the regulatory treatment of NPEs securitisation. This document provides a snapshot of the major regulatory issues identified

The first and overarching issue refers to the lack of a **specific regulatory treatment for NPEs-backed transactions**. Indeed, the securitisation framework in force (**Regulations 2017/2401**, **2017/2402 and 575/2013**, jointly "**Securitisation Framework**" or "**CRR**") sets out capital requirements designed for **performing exposures**, basically exposed to **credit risk** (the risk that the underlying debtors default on their payments). In **non-performing exposures transactions,** as borrowers have already defaulted, cash flows to repay the ABS securities need to be generated through the workout process (typically by enforcing the collaterals or by renegotiating the loan with the borrower).

As a consequence, the main risks arising from NPEs securitisations are **collateral valuation risk** (deriving from potential mistakes in the pricing of the underlying assets) and **workout risk** (deriving from the potential low performance of the servicer).

Additionally, performing and non-performing securitisations are different in terms of objectives and servicing models. While **performing loans transactions** are primarily aimed to **provide liquidity** for the originator and envisage a **passive servicing** model, **NPEs transactions** are usually **structured to dispose the assets from the balance sheet**. Within this context, **active servicing** models (involving independent servicers) are a more common practice.

Despite these differences, both types of transactions fall under the same prudential framework, based on standard credit risk concept. **An important consequence is that capital requirements for NPEs securitisations result harsh every time they are computed with approaches that do not make reference to tranches' external ratings**.

This issue gets particularly relevant because the securitisation framework has switched the "**hierarchy of approaches**", that now allow banks to rely on internal ratings and employ external ratings only on a last resort basis.

Namely, banks have to implement the risk weight calculation methods according to the following priority scheme: firstly, the Securitisation IRB Approach ("**SEC-IRBA**"); secondly, the Securitisation Standardised Approach ("**SEC-SA**"); lastly, the Securitisation External Ratings Based Approach ("**SEC-ERBA**").

The punitive capital charges resulting from **SEC-IRBA and the SEC-SA also affect the senior tranches typically retained by originators banks**, thus hampering the well functioning of the market for NPEs. To address this issue the EBA proposes several amendments to the securitisation framework (page 3).

Besides, similar excess in capital requirements occurs with **caps calculation**, calibrated for performing loans. While NRPPD[1] for performing exposures is limited and captures credit risk, for NPEs NRPPD is wider and reflects workout and collateral valuation risks. This proposes **another concern in relation to RW**. For this reason, the EBA recommends a **look-through approach** for the less risky tranches (page 3).

EBA also discusses the **risk retention rule** (page 4). The framework provides several methods by which the rule can be implemented; while one of the methods applies the retention rule on the nominal value of the **sold/transferred tranches**, the other refers to the nominal value of the **securitised exposures**. Since in NPEs securitisations these two values dramatically differ, the adoption of a different approach may have a sounding impact. Furthermore, the EBA suggests to expand the list of actors bounded by the retention rule ("**skin in the game**") as the current one is deemed too narrow.

[1] "Non refundable purchase price discount", the difference between NPE's Gross Book Value and the price paid to buy the assets. In the securitisation framework it is treated as a credit enhancement covering the first loss.

Source: Opinion of the European Banking Authority to the European Commission on the Regulatory Treatment of Non-Performing Exposure Securitisation, October 23rd, 2019

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Regulatory capital requirements

EBA acknowledges that the **current calculation of capital requirements for NPEs securitisation produces some issues**, namely:

- Capital charge calculated under SEC-IRBA and SEC-SA is significantly larger than those calculated applying the SEC-ERBA approach or, in limited cases, is lower when using the SEC-IRBA with supervisory values of LGD (i.e. for Institutions using F-IRB rating models)
- Miscalibration of the risk embedded in the transaction, due to the application of the p correction factor envisaged by the SEC-IRBA and the SEC-SA approach

Thus the EBA proposes a number of interventions to tackle these issues, which may be summarized in:

a) Corrective measures regarding the regulatory calculation methods (i.e. SEC-IRBA e SEC-SA)

b) Fine tunings on the requirements related to the caps on capital requirements for NPEs securitisation

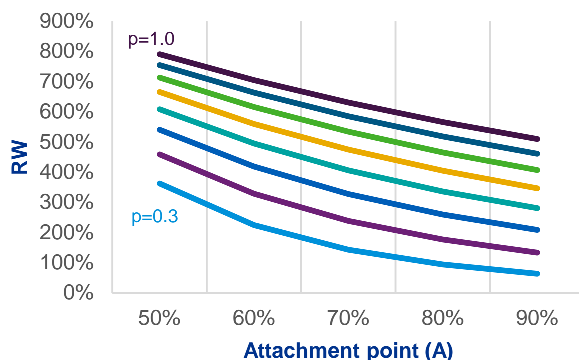
As regards **point a),** EBA lists a few macro-items to be considered by the European Commission when reviewing the CRR requirements, which are:

- **Definition of the scope** of the "NPEs securitisations", including setting a minimum level of NPEs to be included in the securitised pool
- **P-factor level specific** for NPEs securitisation
- Calculation of the inputs to be used in the formula taking into account the level of the NRPPD
- **Net book value approach** for the computation of Attachment (A) and Detachment (D) Point
- A **specific treatment for the "mixed pools"**, i.e. securitised pool featuring both performing and non-performing exposures

Among other measures, the EBA put emphasis on the revision of the p-factor calculation. Indeed the current calibration is considered inappropriate as **in NPEs transactions there is no need to have the p-factor set at a minimum level equal to 0.3 (SEC-IRBA) or to 1 (SEC-SA)**. These values have been determined having in mind performing securitisation, where the p-factor has to cover the risk that the Attachment Point fails to cover the PD, i.e. the observed default rate becomes higher than the expected PD. This risk may be deemed not material in NPEs securitisation where the PD is by definition 100%.

As a consequence, the EBA proposes to reduce the minimum applicable value of the p-factor for NPEs transactions both for SEC-IRBA and SEC-SA.

The graph below reports an illustrative example showing that lowering the current p-factor value pushes down risk weights.



While for the **point b)** related to caps calculation, the EBA suggests the adoption of the so-called "**full net basis calculation**", where the expected losses and the exposure values (as referred to in Article 267(3) and Article 268(1) of the CRR), should be computed netting the amount of the NRPPD (and any additional SCRAs, in the case of the originator). This proposals aims at reflecting in the regulatory framework the fact that the GBV of the NPEs is materially discounted when transferring the assets to the SPV which issues the notes. The caps should therefore be calculated in consistency with the residual value of the NPEs.

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Risk retention rule

As per **article 6** of **Regulation 2017/2402**, **entities such as the originator, the sponsor or the original lender of a securitisation shall retain a material net economic interest in the securitisation of not less than 5%** ("**Risk retention**").

That interest shall be measured at the origination and shall be determined by the notional value for off-balance-sheet items.

For the above-mentioned retention of a material net economic interest of not less than 5%, only the following methods qualify:

(a) The retention of not less than 5% of the nominal value of each of the **tranches sold or transferred** to investors;

(b) If revolving securitisations or securitisations of revolving exposures occur, the retention of the originator's interest of not less than 5% of the nominal value of each of the **securitised exposures**;

(c) The retention of randomly selected exposures, equivalent to not less than 5% of the nominal value of the **securitised exposures**;

(d) The retention of the first loss tranche and, where such retention does not amount to 5% of the nominal value of the securitised exposures, other tranches should be retained so that the retention equals in total not less than 5% of the nominal value of the **securitised exposures**;

(e) The retention of a first loss exposure of not less than 5% of **every securitised exposure** in the securitisation.

Since in NPEs securitisations, the value of the issued notes can be materially lower than the GBV of the securitised portfolio, applying a 5% retention to the sold/transferred notes (approach (a)) instead of securitised exposures (approaches from (b) to (e)) could not be enough in order to retain a sufficient net economic interest in the transaction.

The **risk retention rule** aims to **avoid adverse selection** and **moral hazard** during the origination process and the following securitisation structuring.

According to the active Securitisation Framework, the list of parties bounded by the retention rule includes originators, sponsors, and original lenders.

However, the EBA suggests that **the list of parties bounded by the retention rule should be wider since there could be other parties potentially allowed to behave opportunistically.** Precisely, **EBA's opinion is that the before mentioned list should also include the independent servicer**, since under certain scenarios it has a comparable interest in an optimal workout of the assets.

As a matter of fact, the investors (which have the greatest securitisation success interest) will often, due to know-how limitations of workout procedure details, outsource servicing to an independent actor. In addition, investors prefer that the appointed servicer(s) retain a certain percentage of the first loss tranche in order to enhance servicer involvement in the process chain and to show "**skin in the game**", even if according to the current regulation, the independent servicers are not obliged to retain a net economic interest in the transaction since they do not fall within the "originator", "sponsor" or "original lender" definitions[2].

[2] As per article 2(3-5-20) of Regulation 2017/2402

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