EUROPEAN BANKING AUTHORITY

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23 October 2019

Opinion of the European Banking Authority to the European Commission on the Regulatory Treatment of Non-Performing Exposure Securitisations

Background

1. Many credit institutions in the EU are currently holding large stocks of non-performing exposures ("NPEs")[1] as a legacy of the 2008-09 financial crisis and the subsequent Euro crisis and market and regulatory pressures are exerted on them to dispose of their NPE pools as quickly as possible. A speedy reduction of NPE levels in credit institutions' balance sheets is instrumental to strengthening financial stability, restoring the flow of credit to the real economy and, thus, resuming and ensuring economic growth.

2. However, the pace of NPE reduction has been relatively slow in recent years due to various market structural constraints, for instance the high costs for specialist NPE advisors and intermediaries, the perceived lack of transparency on prices, the large bid/ask spread, the limited pool of buyers and certain legal and execution impediments. The Council of the EU acknowledged 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"[2] and the European Commission tabled various legislative proposals to remove those impediments consistent with the Council's Action plan.

3. The purpose of this opinion is to examine the role of securitisation as a funding tool for reducing NPEs in credit institutions' balance sheets and outline the specific constraints on this role arising from the securitisation regulatory framework in EU law, which were not addressed by the Council's Action plan-related legislation.

[1] Non-performing exposures ("NPEs") are bank loans and other financial exposures where the obligor has defaulted or is likely to default. An obligor defaults on their exposure where they fail to repay its principal and/or interest when due and such failure to pay continues for a specified time period, which may be 90 or 180 days depending on industry practice and type of exposure.

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

Legal basis

4. The EBA's competence to deliver this opinion is based on Article 34(1) of Regulation (EU) No 1093/2010[3], as the regulatory treatment of NPE securitisations under EU law relates to the EBA's area of competence.

5. In accordance with Article 14(5) of the Rules of Procedure of the Board of Supervisors[4], the Board of Supervisors has adopted this opinion which is addressed to the Commission.

Regulatory constraints on NPE securitisations[5]

6. Whilst credit institutions are able to dispose of NPE portfolios through bilateral sales, securitisations can be used to enhance the overall market capacity to absorb NPEs from credit institutions' balance sheets at a faster pace and larger rate than otherwise possible through bilateral sales only. This enhancing role is the consequence of securitisations' structure in tranches of notes with various risk profiles and returns, which enables larger transactions and appealing to a more diverse investor pool than bilateral sales.

7. This tranched structure results in NPE transactions being captured by the EU securitisation regulatory framework[6]. The assets backing NPE securitisations are, however, economically and financially distinct from those of "performing" transactions which underpin the framework. The key difference lies in the type of securitised risk: while in "performing" transactions the investors in the notes bear the risk of the borrowers' defaulting on their payments (credit risk), the assets in NPE securitisations are already defaulted or deemed as defaulted. The NPEs are securitised at a discount on their nominal or outstanding value, which reflects the market's valuation of those NPEs after discounting the portfolio's losses and assessing *inter alia* the likelihood that the "workout" process (that is, the process of restructuring the NPEs through renegotiation of the debt with the obligor or the foreclosure of the security) may generate sufficient recoveries to cover the net value of the NPEs (that is, their nominal or outstanding value minus the non-refundable purchase price discount or "NRRPD"). The risk for investors is, therefore, that the workout of the NPEs generates insufficient recoveries to cover that net value. The originator of the assets, for its part, will adjust in its balance sheet the amount of its own-calculated loss provisions and other specific credit risk adjustments ("SCRAs") to reflect the amount of the NRPPD.

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[3] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

[4] Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 27 November 2014 (EBA/DC/2011/01 Rev4).

[5] For the purposes of this opinion, "NPE securitisations" are transactions backed by pools comprised exclusively or almost exclusively by defaulted bank loans and other similar non-performing exposures at the time of inception.

[6] The references to "securitisation framework" or "framework" in this opinion should be understood as Regulation 2017/2401 (the "Securitisation Regulation"), which sets out the substantive legal basis applicable to these transactions, and Regulation 575/2013 (the "CRR"), which sets out their capital requirements.

8. Regulatory constraints on NPE securitisations ensue in those instances where the framework fails to take adequate account of the distinctive economic substance of these transactions (in particular the pre-eminent risk of incorrect valuation of the NPEs embedded in them), as opposed to securitisations backed by "performing" assets (where credit risk is the main capital determination driver). Those constraints affect EU credit institutions and investment firms ("institutions") mainly as potential investors in the notes and, concretely, as regards:

   a) the regulatory capital requirements on holdings of NPE securitisations under the CRR, which produce seemingly disproportionate capital charges when compared to relevant benchmarks. For instance, the positions in these securitisations carry capital charges several times larger under the now pre-eminent regulatory capital calculation methods based on the capital requirements for credit risk of the underlying portfolio (the SEC-IRBA and the SEC-SA) than under the external-ratings based method (the SEC-ERBA). The same overshooting of capital requirements occurs in relation to the caps for securitisations (the look-through approach and the overall capital requirements approach) where the calculation of the caps does not offset the NRPPD from the expected losses and the exposure value of the portfolio of NPEs backing the securitisation; and

   b) certain requirements under the Securitisation Regulation leading to compliance difficulties. For instance, the "originator", "sponsor" or "original lender" must retain an on-going net economic interest in the securitisation of not less than 5% of the nominal value of the underlying exposures or the securitisation positions, depending on the method applied under that Regulation. The retention methods using the nominal value of the underlying exposures disregard the exposures' discounted price and, as a result, overstate the amount to be retained for the purposes of meeting this requirement. Furthermore, the list of entities subject to the risk-retention obligation does not include the independent servicer.

9. These securitisation-specific constraints, together with other NPE market-wide constraints as referred to in paragraph 2, lead to higher funding and transaction costs, depress the price of assets, increase the originating institution's losses and make securitisations an unattractive funding tool for originators to reduce their stock of NPEs. Insofar as institutions provide the main source of senior funding for NPE securitisations, the capacity of this market to absorb NPEs from credit institutions' balance sheets remains impaired and largely restricted to funding from the non-bank sector, which may ultimately slow down the banking system NPE clean-up process, or overly reliant on public sector support.

10. As there are other factors at play, removing or easing regulatory constraints is not the only condition to the development of NPE securitisations and the broader NPE market, but it is a necessary one. Hence, the EBA is of the view that such regulatory constraints are significant, merit attention and should be addressed promptly. Accordingly, this document provides the EBA's detailed opinion on the matters summarily described above and recommendations on the matters that the European Commission may wish to reassess or review in the EU securitisation framework for the purposes of future legislative amendments of that framework.

The matters referred to in paragraphs 11 to 23 of this opinion are currently subject to an on-going assessment at the Basel Committee on Banking Supervision.

Opinion to the European Commission on the treatment of NPE securitisations in the CRR

Calibration of the securitisation regulatory capital methods for NPEs

11. The SEC-SA and the SEC-IRBA yield capital charges for NPE securitisation positions significantly larger than those resulting from applying the SEC-ERBA to the same positions or to positions exhibiting the same risk profile.

12. In the limited cases where supervisory loss-given default ("LGD") levels may be used under the SEC-IRBA, these are likely to have the opposite effect and lead to lower capital charges than under the SEC-ERBA. These charges may, in particular, be significantly lower for the mezzanine and junior tranches.

13. The securitisation framework uses the credit risk framework's gross book value approach on the underlying portfolio to setting capital requirements for the securitisation positions and treats the NPEs' NRRPD as credit enhancement/over-collateralisation for the securitisation tranches. The respective comparatively high or low capital charges that result from this framework may be indicative that the securitisation regulatory capital methods miscalibrate the specific risks embedded in NPE securitisations. This miscalibration would be due to, in each case:

    a) the disproportionate impact of the framework's non-neutrality (p) correction factor when applied on the grossed-up capital requirements derived from the SEC-SA and the SEC-IRBA; and

    b) supervisory LGD levels lower than the NRPPD, where those may be used under the SEC-IRBA, and the failure of the (p) factor to correct for non-neutrality purposes in these cases.

14. It is the EBA's opinion that the regulatory capital calibration for securitisations as currently laid down in the CRR should be reassessed to address the technical shortcomings referred to herein. The EBA recommends the European Commission to consider the merits of reviewing the CRR in relation to the following:

    a) the scope of "NPE securitisations" and including, in particular, a requirement that the securitised pool comprise a mandatory minimum level of NPEs from origination/inception;

    b) the desirable level of the (p) factor for NPE securitisations for the purposes of Articles 259(1) and 261(1) of the CRR;

    c) the inputs to the formulaic approaches (SEC-IRBA and SEC-SA) to better reflect the loss-absorbing effect of the NRPPD in NPE securitisations;

d) using the net book value approach within the securitisation framework when determining attachment (A) and detachment (D) points for the setting of capital requirements for NPE securitisations; and/or

e) an appropriate prudential treatment for pools of securitised exposures comprising both performing and non-performing exposures ("mixed pools") for the purposes of the securitisation framework.

15. Without prejudice to thoroughly assessing all the suggested alternatives, the EBA's view is that any amendments to the calibration in the CRR to deal with the NPE securitisation-specific issues referred to in this opinion should seek to resolve those issues as quickly as possible and, at the same time, preserve the integrity and consistency of the current securitisation framework. Thus, the preferred option should be capable of being applied to (i) both NPEs and performing assets; (ii) purchase price discounts and SCRAs; (iii) all securitisation tranches from first loss to senior; (iv) all institutions, whether using the SEC-SA or the SEC-IRBA; and (v) at all times, from issuance to maturity. One such option consistent with these principles would be to adjust the current (p) factor down from current levels (0.3 floor for SEC-IRBA and 1 for SEC-SA) where the portfolio's loss levels increase. Furthermore, any instances of undercalibration should, at the same time, be prevented.

Caps for NPE securitisations

16. The caps for securitisations laid down in Articles 267 and 268 of the CRR were designed to ensure consistency with the non-securitisation framework and as a safeguard against the overly conservative capital requirements on relevant positions that may result from the securitisation regulatory capital methods. Accordingly, the caps should enable the investor institution to apply to the relevant securitisation positions (the senior position in the case of the look-through approach) the same or substantially the same capital charges that it would apply to the underlying exposures as if these "had not been securitised", that is, as if the investor had a direct exposure to the underlying.

17. The caps under the SEC-IRBA are, however, open to conflicting interpretations. The references to "expected losses" and "exposure value" in paragraph (3) of Article 267 and the reference to "expected losses" in paragraph (1) of Article 268 are not explicit as to whether these amounts should be calculated net or gross of the NPEs' NRPPD and any additional SCRAs (in the latter case, for the originator only). If the "expected losses" and the "exposure value" of a portfolio of NPEs are calculated gross of their NRPPD for these purposes, the resulting capital charges greatly exceed those that result from the securitisation methods and, as a result of this, the caps fail to meet their intended purpose. This interpretation relies on the understanding that the securitisation framework implicitly refers back to the definition of "expected loss" in Article 5 (3) CRR. "Expected losses" are defined therein as the "ratio of the amount expected to be lost on an exposure from a potential default of a counterparty or dilution over a one-year period to the amount outstanding at default", which is calculated without netting the amount of SCRAs.

18. The EBA is of the opinion that a "full net basis calculation" should be the preferred approach for the purposes of applying the caps under the SEC-IRBA to NPE securitisations. A full net basis calculation means that both the "expected losses" and the "exposure value" referred to in Article 267(3) and the "expected losses" referred to in Article 268(1) of the CRR should be net by the amount of the relevant NPEs' NRPPD and, in the case of the originator, any additional SCRAs. The NRPPD should be net in this manner to enable the direct exposure to the underlying portfolio that the caps are predicated on, taking into account that the underlying exposures are transferred at inception to a securitisation SPV and the transfer at a discount has the effect of writing off the underlying exposures' expected losses and leaving a residual value subject to the risk that recoveries may be insufficient to repay that residual value (unexpected losses). A full net basis calculation meets the purpose of the caps as a safeguard against unduly high capital requirements because:

    a) it results in largely the same risk-weighted exposure amounts that the investor institution would be required to hold on the NPEs should it had acquired them directly at the same discount level by application of Article 159 of the CRR; and

    b) it prevents the overshooting of capital requirements that results from a gross basis calculation. Furthermore, it also prevents an undershooting of capital requirements that results from a partial net basis calculation, that is, where only the expected losses of the NPEs, but not their exposure value, is offset by their NRPPD.

19. The full net basis calculation of the caps should require a sufficiently loss-absorbing NRPPD and, accordingly, the NRPPD should be adequately sized to cover all the underlying exposures' expected losses. This approach to calculating the caps should, however, not be applicable to performing assets securitised below par, insofar as in this case the discount on the nominal or outstanding value of the assets does not have loss-absorbing features.

20. Where the SEC-SA applies, it is the EBA's opinion that the investor institution should be able to apply a 100% risk weight for the caps for securitisations where the originator was permitted to apply this same risk weight on the underlying portfolio in accordance with Article 127 of the CRR and the amount of NRPPD is at least equal to or larger than the SCRAs made by the originator.

21. The EBA, therefore, recommends that the European Commission take action to clarify that, where the caps for securitisations laid down in Articles 267 and 268 of the CRR are applied to NPE securitisations:

    a) the "expected losses" and "exposure value" referred to in paragraph (3) of Article 267 and paragraph (1) of Article 268 under the SEC-IRBA should be calculated net of the NRPPDs and, where applicable in the case of the originating institution, additional SCRAs;

    b) the applicable risk weight for SEC-SA purposes should be 100% where the originator was able to apply that same risk weight on the underlying portfolio pre-securitisation in

accordance with Article 127 of the CRR and the NRPPD exceeds the percentage of SCRAs made by the originator as set out in that Article; and

c) the matters referred to in points (a) and (b) do not apply to performing assets where these are securitised below par.

22. Subject to paragraph 21, it is also recommended that the European Commission consider the convenience of amending Article 267 of the CRR to provide that the capital floor in Articles 259(1) and 261(1) of the CRR applies to the look-through approach for the purposes of NPE securitisations.

23. The matters referred to in paragraphs 21 and 22 would require defining a class of "NPE securitisations". In relation to this, it should be noted that the overarching definition referred to in paragraph 14(a) and the treatment of "mixed pools" referred to in paragraph 14(c) should be assessed for their potential application to the caps as well.

24. The EBA advises the European Commission to take into account any developments at the Basel Committee on the regulatory treatment of NPE securitisations for the purpose of implementing the recommendations referred to in the preceding paragraphs.

Opinion to the European Commission on the treatment of NPE securitisations in the Securitisation Regulation

25. The EBA considers that there are certain provisions in the Securitisation Regulation that do not take duly into account the specific features of NPE securitisations and lead to compliance issues for participants in this market.

26. As pointed out above, these relate to the requirements on risk retention, insofar as the risk retention amount for some methods is calculated on the nominal value of the NPEs, rather than on the discounted value after applying the NRPPD, and overstates the amount to be retained as a result.

27. Furthermore, the list of entities obliged to retain as per the definition of "originator", "sponsor" or "original lender" in the Regulation may be too narrow and fails to capture other parties with a more prevalent interest in the successful workout of the assets and, therefore, a more relevant "skin in the game" and proper alignment of interests with the investors in the bonds. This is the case of the independent servicer in some transactions, in particular where this party retains the mezzanine and/or the junior tranche and its fees are payable out of the collections from the assets as part of the securitisation's waterfall.

28. In addition, the obligation to "verify" that a third party originator or original lender applied "sound" and "well defined" credit granting criteria raises difficulties where the securitised assets are NPEs.

29. Hence, the EBA advises the European Commission to consider the convenience of reviewing the Securitisation Regulation to provide for:

    a) as regards the risk retention requirement as per Article 6 of the Securitisation Regulation:

        – a specific risk retention amount calculation method for NPE securitisations that takes into account the NRPPD on the assets' nominal value;

        – that the independent servicer be entitled to discharge the retention obligation where its interests in the successful workout of the assets are appropriately aligned with those of the investors in the bonds ("skin in the game");

    b) a specific treatment for NPE securitisations and other third party-originated assets securitisations as regards the obligation to verify that the originator or original lender applied "sound and well defined credit granting criteria" as laid down in Article 9(1) and (3) of the Securitisation Regulation[7].

30. This opinion will be published on the EBA's website.

Done at Paris, 16 October 2019

José Manuel Campa
Chairperson
For the Board of Supervisors

[7] See EBA's response to Q&A 4368 which refers to paragraphs (1) and (3) of Article 9 of the Securitisation Regulation https://eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2018_4368

ANNEX

1. NPEs and securitisations

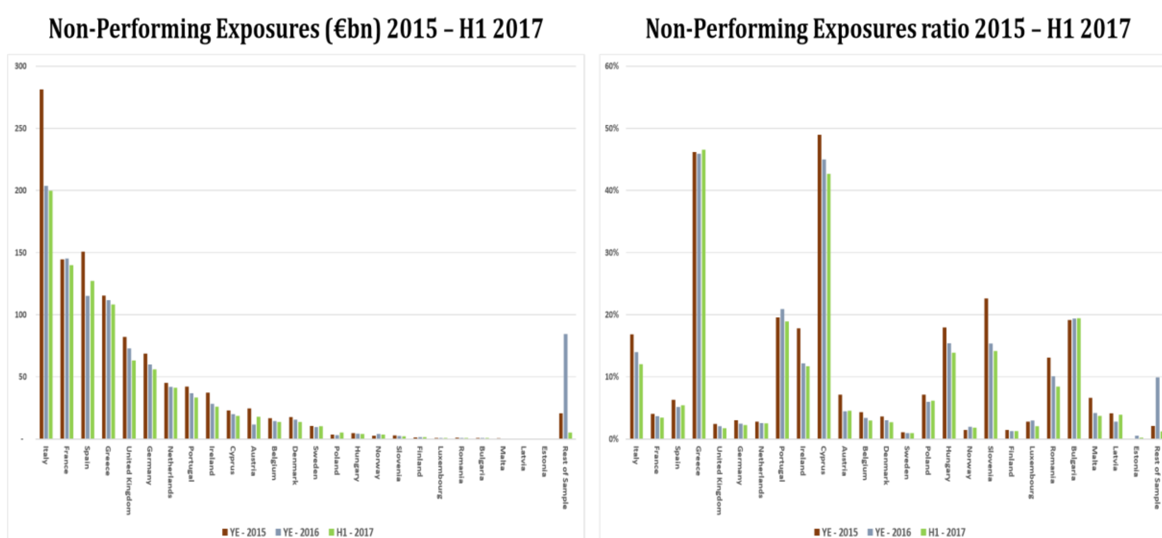
1.1 Background

Non-performing exposures ("NPEs") are bank loans and other financial exposures where the obligor has defaulted or is likely to default. An obligor defaults where they fail to repay the relevant exposure's principal and/or interest when due and such failure to pay continues for a specified time period, which may be 90 or 180 days depending on industry practice and type of exposure.

Financial crisis and economic recessions typically result in credit institutions' holding high stocks of NPEs, as was the case in the Union (namely in certain of its Member States) following the 2008-9 crisis and the subsequent Euro crisis. High levels of NPEs can weigh on economic growth as they reduce credit institutions' profitability and ability to lend.

As the EBA's 2017 transparency survey found, the absolute levels of NPE's remained high by historical standards at €893bn. Whilst the NPE ratio across the 132 largest banks in the EU declined from 5.4% to 4.5% during the 12 months to June 2017, it remained above 10% in one third of the 25 Member States surveyed. In some Member States, the drop in NPE ratios can be partly attributed to government schemes:

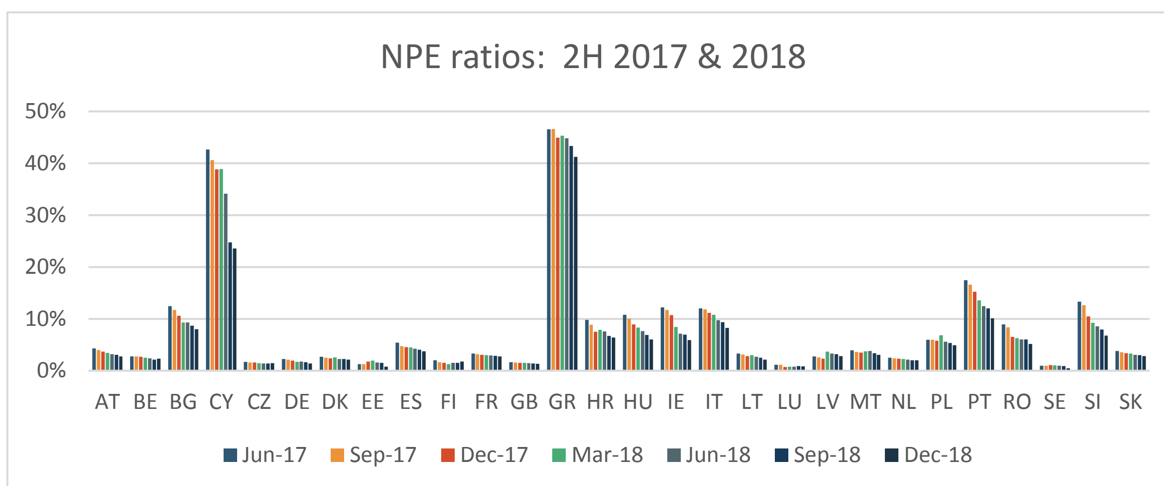
Figure 1



NB: 1 - Source: EBA Transparency Exercise 2016 & 2017. The data does not include NPEs held by state-owned bad banks and also do not reflect asset sales in the second half of 2017. Nevertheless, EBA data provide comprehensive baseline reading of the outstanding NPE pool in Europe.

More recently (second half of 2017 and 2018), the NPE ratio levels continued to fall throughout the Union but at a slow pace, more notably in some Member States with large outstanding NPE stocks:

Figure 2



Source: EBA

Credit institutions in the EU are subject to market and regulatory pressures to reduce their stock of NPEs as quickly as possible, and financial stability is largely dependent on the effectiveness and credibility of this clean-up process. As data show in figures 1 and 2, however, the pace of reduction has been relatively slow.

Acknowledging the need to accelerate that pace, the Council of the EU adopted a comprehensive "Action plan to tackle non-performing loans in Europe" (the "NPE Action Plan") with initiatives on the key areas of: (i) supervision, (ii) structural reforms of insolvency and debt recovery frameworks, (iii) development of secondary markets for distressed assets, and (iv) fostering restructuring of the banking system.

In particular, the NPE Action Plan called on the European Commission to develop a prudential backstop to address under-provisioning of NPEs and concrete initiatives to "remove impediments to the transfer of NPEs by banks to non-banks and their ownership by non-banks", including a licensing regime for third party loan servicers. Consistent with this mandate, the European Commission came forward in March 2018 with various NPE-related legislative proposals which included the following:

- an amendment of Regulation 575/2013 (the "CRR") to, *inter alia*, introduce a minimum coverage levels for newly originated loans that become non-performing and a common definition of "non performing exposures" for regulatory capital purposes[8]; and

[8] New Art. 47a(3) of the CRR defines NPEs as an exposure meeting either of the following conditions:

- a new directive on credit servicers, credit purchasers and recovery of collateral.

This opinion examines certain regulatory issues concerning the treatment of NPE securitisations under the EU law regulatory framework for securitisations, which were not the subject of the NPE Action Plan. These regulatory issues raise constraints on the use of securitisations for credit institutions to fund the disposal of their NPEs and, unless properly addressed, may have the effect of delaying the process of reducing NPE holdings for the banking system as a whole. Against this backdrop, the opinion points to the matters that the European Commission may wish to review in the EU securitisation framework with a view to easing or removing these constraints.

1.2 NPE disposals: portfolio sales and securitisations

Credit institutions may run off their NPEs on balance sheet. In this case, the credit institution will have to calculate and apply loss provisions on the defaulted exposures as an accounting deduction. Such deduction will amount to the difference between the money owed by the obligors (their nominal or outstanding value) and the credit institution's most current own estimate of the amount that it will actually receive ("general and specific credit risk adjustments" or "SCRAs").

Where credit institutions choose not to run off their NPEs on balance-sheet, they will dispose of them in favour of a third party buyer at a large discount. NPEs may be disposed of via outright portfolio sale to one or more buyers or via securitisation, in which case a special purpose vehicle ("SPV") will purchase the NPEs and raise funding from the market on the back of those NPEs. In both these cases, the seller/originator credit institution will agree with the buyer on a non-refundable purchase price discount (the "NRPPD") on the NPEs' nominal or outstanding value (their gross value). The NRPPD reflects the buyer's assessment of the loss level in the portfolio, collateral management costs (including costs of disposal), investor's cost of capital and the likelihood that the workout of the NPEs may generate sufficient recoveries to, at a minimum, cover the NPEs' net value (that is, their gross value minus the NPRRD). The credit institution will adjust any provisions previously made on the NPEs to reflect the amount of the NRPDD, and hence the transfer of the NPEs may lead to the credit institution's accounting for a larger or smaller loss than initially provisioned on its balance sheet.

Though both outright portfolio sales and securitisations have similar features and serve the same purpose, they should be seen as largely complementary in light of their different characteristics. Outright portfolio sales are simpler transactions that can be completed more quickly as they merely involve a bilateral agreement. They are the preferred disposal tool while the NPE market remains small and largely private, typically at the initial stages after the onset of a period of crisis. An important advantage of portfolio sales is that the purchaser can select the servicer, as an efficient

a) it is in default in accordance with Art. 178;

b) it is "impaired" in accordance with the applicable accounting framework;

c) it is "under probation" as per par. 7 of that Article, where additional forbearance measures are granted in relation to it or where the exposure becomes more than 30 days past due;

d) where the exposure has the form of a drawn down commitment, it would be likely not to be paid back in full without realizing the collateral; or

e) where the exposure has the form of a financial guarantee, it is likely to be called by the guaranteed party.

workout of the assets is essential to ensuring recoveries and producing a stream of cashflows (see more on this in section 1.4 below).

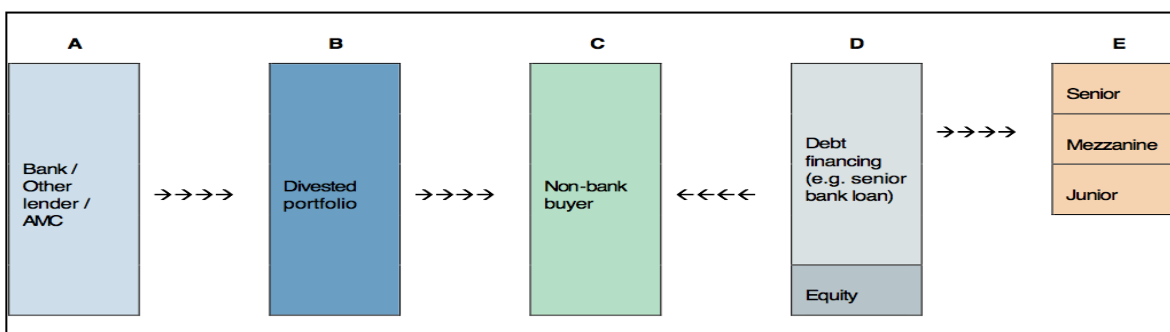
Securitisations are, by contrast, more complex and costlier transactions, but they offer a number of advantages compared to an outright portfolio sale:

- the tranching of liabilities allows offering different notes with various risk profiles and returns and, thus, can appeal to a larger and more diverse investor pool;
- as a consequence, the overall interest rate used to discount future cash flows is normally lower for a securitisation. Hence, the seller can obtain a higher transfer price for the NPEs and reduce the potential loss between the book value and the sale price of the NPEs;
- buyers of the senior notes may benefit from an exposure to a high yielding asset with the additional protection offered by the subordinated tranches. Buyers of the junior notes may, in turn, benefit from better rates of return as compensation for the higher risk compared to a bilateral portfolio sale.

Hence, as securitisations enable to dispose of larger NPE portfolios, they help to expand overall market capacity to absorb NPE portfolios from institutions' balance sheets at a larger and faster rate than through bilateral sales alone. This role becomes more significant when market conditions improve and normalise, typically at later stages following the end of the crisis period that gave rise to the build-up of large NPL stocks, and institutions come under pressure to clean up their balance sheets as quickly as possible.

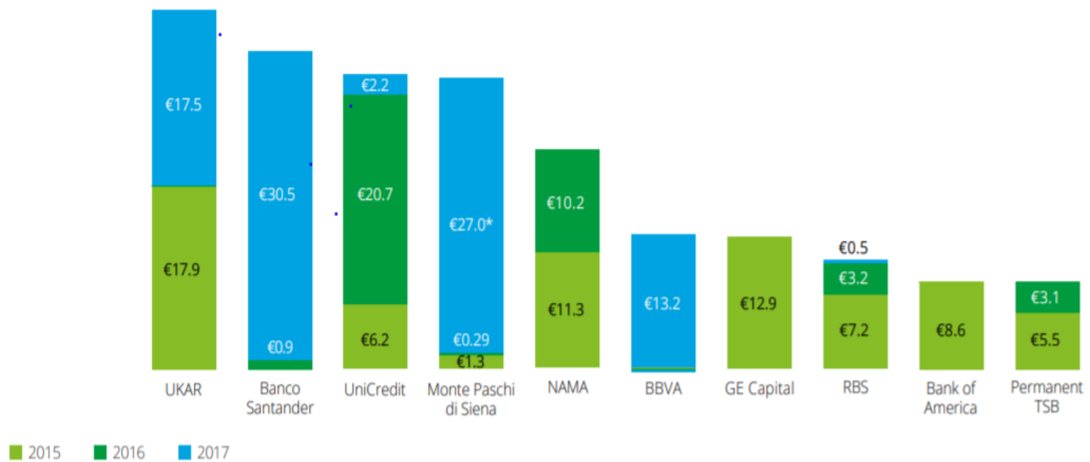
In order to understand that capacity-enhancing role of NPE securitisations, this market needs to be viewed holistically. Institutions may securitise their NPEs directly, but in most cases the accounting derecognition rules do not allow for a "clean break" from these pools that the originator institution seeks to achieve to meet market or regulatory pressures. As a result, institutions more frequently resort to outright portfolio sales to NPE specialist firms such as hedge funds or private equity firms. These firms may, in turn, resort to securitisation as a funding tool and will, typically, sell the senior tranche to other investors while retaining the junior and/or the mezzanine tranche for themselves.

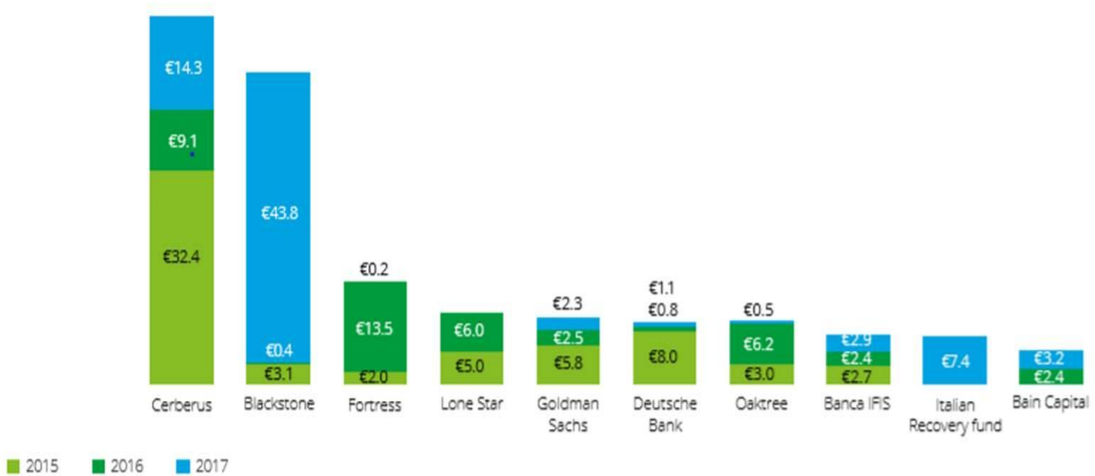
Figure 3



The senior funding of these securitisations is typically provided by institutions and, consequently, their involvement as senior funders allows NPE specialist firms as intermediate originators to purchase additional portfolios from other institutions as remote originators. From a system-wide perspective, this capacity-enhancing role that securitisations can perform will have the effect of speeding up the process of reducing credit institutions' holdings of NPEs.

Figure 4



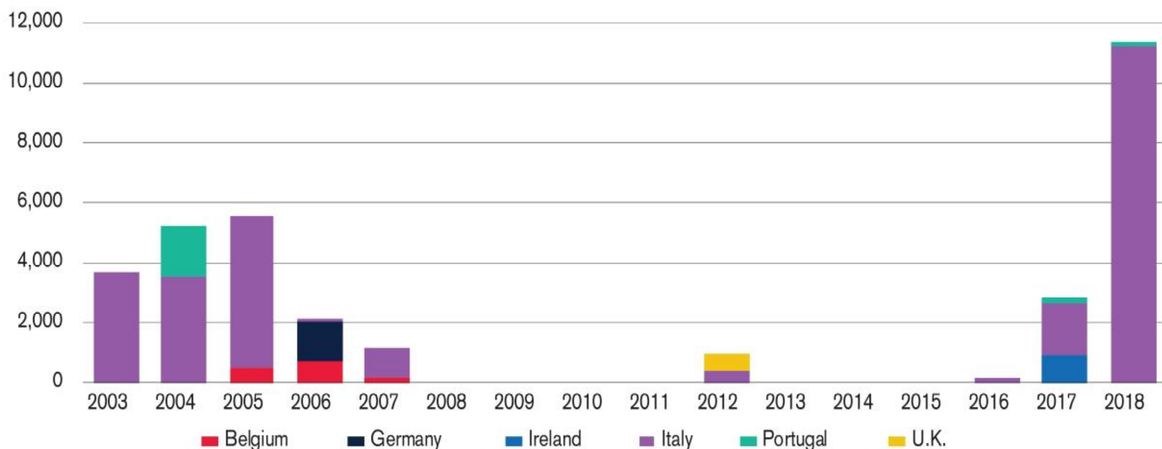


Source: Top NPL buyers and sellers. Deloitte Global Deleveraging Report 2017-2018 Europe. Data as of 31 December 2017.

1.3 NPE securitisations: Regulatory challenges

The data in figure 5 show that securitisations already played this useful funding role for NPE disposals in the past, with transactions in Italy dating back to the 90's. Between 2003 and 2007 there were 15 NPE securitisation transactions with assets originating from various Member States.

Figure 5



Source: DBRS "European Non-Performing Loan Securitisations: Development of a New Asset Class", January 2019. Issuance volume

While the market has revived in recent years following the last crisis, the share of NPEs traded through securitisations remains small compared to outright portofolio sales, which amounted to over €100 billion in 2018, and the pace of NPE reduction relatively slow (in particular, for selected EU Member States as seen under section 1.1). Furthermore, the majority of NPE securitisation deals took place in Italy, aided in some cases by a government scheme introduced in 2016 (*Garanzia Cartolarizzazione Sofferenze)* providing a state guarantee for the most senior tranches in the transaction.

There are various factors currently limiting the growth of the NPE securitisation market, including the high costs for specialist NPE advisors and intermediaries, the perceived lack of transparency on prices, the large bid/ask spread, the limited pool of buyers and certain legal, regulatory and execution impediments. Among the latter, there are legal and regulatory constraints affecting the entire market for NPEs in the EU, such as the "servicing environment", that is, Member States' legal framework and their judicial and extra-judicial infrastructure and remedies for debt restructuring and foreclosure. One of the key aims of the new directive on credit servicing is precisely to improve the "servicing environment" to facilitate the disposal of NPEs, which will indirectly benefit securitisations.

However, other growth-limiting factors are idiosyncratic to NPE securitisations and relate to the treatment of these transactions under the specific securitisation regulatory framework. More concretely, this framework is designed to capture within its scope any financial transaction meeting

the following three structural requirements in Article 2(1) of Regulation 2017/2402 (the "Securitisation Regulation") and regardless of the type of underlying asset:

- payments in the transaction or scheme are dependent upon the performance of the exposure or the pool of exposures;
- the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;
- the transaction or scheme does not create specialised lending exposures (e.g. those possessing all of the characteristics listed in Article 147(8) of Regulation (EU) 2017/2401 (the "CRR").

Whilst NPE financings may use securitisation techniques and structures consistent with this definition, their economics and credit analysis driven by the underlying assets are very distinct from most other securitisations and, as a result, they sit oddly within certain key provisions in the framework which were crafted with "performing" securitisations in mind.

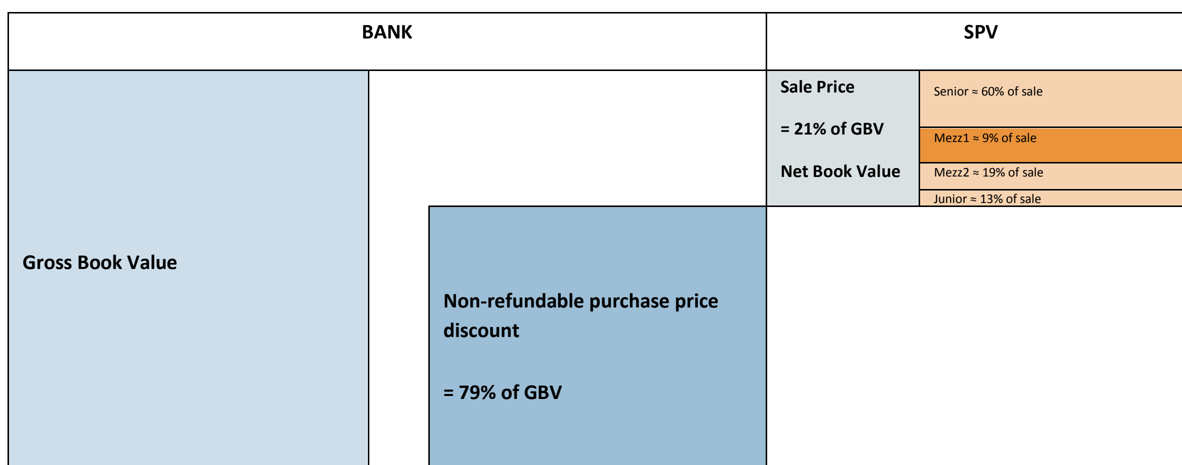
1.4 Distinctive features of NPE securitisations

Indeed, securitisations are typically issued on the back of performing assets with stable and predictable cash flows. The main role of the servicer is to collect already committed payments and pass them on to the bondholders as they become due (this can be characterised as "passive" servicing). Investors in these transactions are essentially exposed to the risk that the underlying obligors default on their payments (credit risk). Defaulted exposures are periodically written off the SPV's balance sheet and the tranches providing credit enhancement written down accordingly.

Securitisations of NPEs are exactly the opposite: as borrowers have already defaulted at the time the bonds are issued, the cash flows to repay the bonds need to be generated through the workout of the exposures, typically by renegotiating the loan with the borrower or by enforcing the security (e.g. by selling or auctioning the asset) (this is "active" servicing and is more akin to asset management). The NPEs will typically remain on the SPV's balance sheet until the end of their workout. Therefore, the risk for the bondholders in an NPE securitisation mainly arises from:

- the correct pricing of the assets (collateral valuation risk), which requires a sufficiently large NRPPD for the recoveries from the NPEs to, at a minimum, cover the net value of the NPEs; and
- the success of the servicer in working out the exposures to generate sufficient recoveries to repay the bonds. In turn, the servicer's success will greatly depend on a sufficiently conducive servicing environment, as referred to above.

Figure 6: **Diagrammatic representation of the NPE securitisation referred to under section 2.2.1(d)**



The securitisation framework's underpinning assumption that the assets were performing at the time they were securitised (thus using their credit risk as the main regulatory driver) leads to unintended outcomes for NPE transactions, namely capital charges for investor institutions seemingly disproportionate relative to certain benchmarks. Such unduly high capital charges discourage investor institutions from providing senior funding on which NPE transactions greatly rely and, in turn, inhibit market growth and the efficient use of securitisation as a funding tool for NPE disposals.

The table below shows the relevant differences between performing and NPE securitisations:

	Performing securitisations	**NPE securitisations**
Profile of securitised loans at inception	Performing exposures at inception. Some of these may become non-performing over the life of the transaction. The main aim of the securitisation is liquidity for the originator.	Non-performing exposures at inception. The transaction is structured with the objective of removing these exposures from the originator's balance sheet.
Servicing	"Passive servicing". The originator typically retains the servicing of the assets	"Active servicing". The NPEs are normally serviced by an independent servicer.
Main driver of risk to bondholders	Credit risk of securitised exposures	Cash flow from NPE workout Collateral valuation risk
Current treatment under securitisation framework	Securitisation framework, which is conceptually based on the credit risk framework.	

Source: BCBS

The EBA considers that the regulatory issues affecting NPE securitisations should be addressed promptly on a sound and prudent basis in order to facilitate the system-wide bank balance sheet bad debt clean-up. The issues relate to certain provisions in both the CRR and the Securitisation Regulation, both of which will be referred to in this opinion as the "new securitisation framework" or the "framework".

Section 2 of this opinion deals with the CRR and section 3 with the Securitisation Regulation. Under each section, a description of the respective issues is followed by the EBA's opinion with, as applicable, the advice to the European Commission on potential revisions of the framework.

It should be noted that the matters referred to in section 2 of this opinion are subject to on-going assessment at the Basel Committee on Banking Supervision.

2. Regulatory capital requirements

2.1 The new securitisation regulatory capital framework

The new securitisation regulatory capital framework was laid down in Regulation (EU) 2017/2401 which amended the CRR to implement in EU law the Basel Committee securitisation standards of 2014 and 2016.

This new framework addresses the shortcomings that became apparent during the financial crisis in the previous regulatory capital requirements: (i) an undue mechanistic reliance on external ratings, which were the preeminent driver to assign capital charges; and (ii) an excessive pro-cyclicality of the capital requirements, as tranches downgrades led to a rapid and sudden increase in capital requirements for credit institutions holding downgraded mezzanine and senior tranches ("cliff effect"). Against this backdrop, Regulation (EU) 2017/2401 made the following key changes to the securitisation regulatory capital framework:

- a set of new regulatory capital calculation methods ("hierarchy of approaches") built on the following calculation drivers:

  a) the credit risk capital requirements of the underlying pool of assets backing the securitisation bonds, thus making those new methods more sensitive to the risk profile of the underlying assets as calibrated under the CRR's credit risk framework and less dependent on external ratings. Institutions must apply the following methods subject to a strict hierarchy (Article 254 of the CRR[9]):

     i) first, the Internal Ratings Based Approach for Securitisations ("SEC-IRBA"), where the investor institution has permission from its supervisor to use its own regulatory capital model to calculate the pool's capital requirements ("Kirb") (Article 255 of the CRR); and

     ii) where the investor is unable to calculate Kirb, the standardised approach for securitisations ("SEC-SA"). The SEC-SA is based on the regulatory-prescribed credit risk formula ("KSA") for the pool (Article 255 of the CRR).

     Only where the SEC-IRBA and SEC–SA cannot be applied and without prejudice to those cases where the hierarchy is inverted as per Article 254(2) and (3) of the CRR, the investor is allowed to use the Securitisation External Ratings-Based method ("SEC-ERBA");

  b) the securitisation tranches' attachment (A) and detachment (D) points (Article 256 of the CRR) and their maturity (Article 257 of the CRR). The attachment point is the threshold, expressed as a percentage, at which losses in the pool would start to be allocated to the

[9] References to CRR articles as amended by Regulation 2017/2401.

relevant tranche. The detachment point is another threshold, also expressed as a percentage, at which the losses in the underlying pool would result in a complete loss of principal for the relevant tranche;

c) non-neutrality correction factors to capture the agency and model risks prevalent in securitisations. These risks result from the liabilities' tranched structure's making the task of modelling the underlying portfolio's credit risk and the allocation of potential losses to the different tranches more complex and uncertain. Hence, the potential for cliff effects as referred to above is a significant concern, namely for the mezzanine tranches. To address this concern, the framework lays down two non-neutrality correction factors:

    i) the (p) factor, a capital surcharge on the tranches relative to the underlying pool's capital intended to produce a higher capital charge for an investment in the securitisation tranches than a direct investment in the underlying. Even though (p) is set at a minimum of 0.3 (30% capital surcharge) for SEC-IRBA (Article 259(1) of the CRR) and at 1 for SEC-SA (Article 261(1) of the CRR) (100% capital surcharge), it operates in practice as an upper limit for the capital surcharge[10];

    ii) the capital floors, by virtue of which the lowest risk weight that may be assigned to the senior securitisation tranche may not be less than 15% (10% in the case of a simple, transparent and standardised -"STS"- securitisation).

- Caps for securitisations that include a "look-through approach" (Article 267 of the CRR) and an overall cap on capital requirements (Article 268 of the CRR), designed to ensure consistency with the non-securitisation framework and as a safeguard against the overly conservative capital requirements on relevant positions that may result from the securitisation regulatory capital methods. Under the look-through approach, an institution investing in the senior securitisation position may apply to this position a maximum risk weight equal to the weighted average risk weight of the underlying exposures "as if these had not been securitised". Similarly, under the overall cap an investor institution using the SEC-IRBA and an originator or a sponsor using any method may apply a maximum capital requirement for the securitisation position that it holds equal to the capital requirements that would apply to the underlying exposures had they not been securitised. The rationale for the caps is that an exposure to the securitisation positions (specifically the senior position in the look-through approach) cannot be riskier than a direct exposure in the same assets, subject in each case to meeting certain conditions.

[10] For example, where K_{IRB} is 80% and p is 0.3, the resulting capital will not be 80% + 80%*0.3 = 104%. The maximum capital add-on will be, at most, 20%, so that the percentage add-on would be at most 20%/80% = 0.25, lower than the initially suggested (p) of 0.3.

2.2 Key challenges for NPE securitisations

The challenges for NPE securitisations arise from the capital requirements that result from:

- the calibration of the pre-eminent securitisation methods: the SEC-SA and the SEC-IRBA produce much larger capital charges for NPE securitisation than the SEC-ERBA for the same positions and those charges appear disproportionate to the actual risk embedded in the securitisation taking into account the protection provided by the NPEs' NRPPD. In the limited cases where the supervisory LGD levels under the SEC-IRBA may be used and these are below the level of the NRPPD, the framework leads to lower capital charges for NPE securitisation positions than the SEC-ERBA and, in particular, the charges for the mezzanine and junior tranches may be significantly lower; and
- the caps for securitisations: the caps are open to conflicting interpretations. Where, pursuant to a gross basis approach, the NRPPD is disregarded for the purposes of calculating the expected losses and the exposure value of the NPEs as inputs to the caps, the resulting capital charges exceed those that result from the securitisation regulatory capital methods and, as a consequence of this, the caps fail to meet their intended purpose as a safeguard against unduly high capital requirements.

2.2.1 Calibration of the securitisation methods

The seemingly disproportionate or inadequate capital charges for NPE securitisation positions under the current methods would derive from:

a. The framework's using gross inputs to the regulatory capital calculation

The SEC-IRBA and the SEC-SA were calibrated against performing portfolios and, consistently, use gross inputs to the capital determination on the assumption that the underlying portfolio exhibits low or inexistent default levels at inception, that these levels may increase over time and that defaulted exposures will be written off the SPV's balance sheet and the tranches providing credit enhancement written down accordingly. The use of a gross book value ("GBV") approach to capital calculation can be observed:

i) in the KA[11] formula for SEC-SA (Article 261(2) of the CRR), insofar as it applies a 50% capital requirement that results from setting delinquency levels at 1 (thus reflecting a 100% default level in the portfolio); and

ii) in the Kirb formula for SEC-IRBA (Article 259 of the CRR), insofar as it uses the grossed-up inputs laid down in Section 3 of the CRR, specifically the NPEs':

[11] KA= (1-W).KSA+W.0.5

- exposure value at default ("EAD"), set at their accounting value gross of NRPPD and any additional SCRAs; and
- loss given default ("LGD"), again disregarding the NRPPD and any additional SCRAs on the portfolio. However, the use of supervisory LGDs as per article 161(1)(a) of the CRR leads to partially offsetting the NRPPD (see next point (b));

whilst, at the same time, the investor institution is unable to account for any SCRA shortfall/excess over expected losses (the "IRB shortfall/excess") in the manner available to the originator in accordance with Article 159 of the CRR.

The use of gross inputs is required for performing exposures because institutions are exposed to their gross value (nominal or outstanding amount) and must hold capital to protect against both expected and unexpected losses potentially arising from such level of exposure. In the case of NPEs, their transfer to the SPV at a discount should write off all (or substantially all) expected losses ("ELs") in the portfolio and leave only a residual exposure (their net value).

The NRPPD offers protection to the bondholders insofar as the larger its size, the smaller the amount of recoveries needed from the NPEs to repay in full that residual exposure and, hence, the bonds. The framework treats the NRPPD as a first loss piece and, therefore, as credit enhancement (overcollateralisation) to the securitisation tranche holders when the attachment (A) and detachment (D) points are applied on the SEC-IRBA or SEC-SA-derived capital requirements to assign risk weights to those tranches. However, this treatment as credit enhancement is insufficient because the securitisation capital methods use grossed-up inputs and, as a result, do not sufficiently recognise the loss-absorbing effect of the NRPPD.

b. The use of lower than NRPPD supervisory LGD levels under the SEC-IRBA

Where, by contrast, supervisory LGD levels may be used under the SEC-IRBA (Article 161(1)(a) of the CRR), these are likely to be much lower than typical NRPPD levels for NPEs. This gives, as a result, a significant offsetting effect in the amount that the NRPPD exceeds the supervisory LGD level, although it should be noted that this is an unintended consequence as fixed LGD levels were designed for purposes other than to deal with defaulted assets. Whilst this approach leads to lower capital charges for all securitisation tranches than under the SEC-ERBA, those charges may be significantly lower for mezzanine and junior tranches.

Under this method and also contrary to the SEC-SA and the SEC-IRBA subject to own calculated LGD levels (advanced IRBA), the (p) factor does not produce a material impact in terms of non-neutrality correction (see next point).

Supervisory LGD levels may, however, only be used in limited cases (corporate exposures).

c. The impact of the non-neutrality (p) factor on capital intensive portfolios such as NPEs

The (p) factor was designed to enhance the sensitivity of the framework to account for the risk that the attachment point (A) for each tranche fails to adequately capture the probability of default ("PD") in the underlying pool (risk of undercapitalisation of mezzanine tranches or cliff effect as described above). In other words, the purpose of the capital surcharge that results from (p) is to provide an additional layer of conservatism against higher than expected/modeled PD levels. The following graph illustrates the risk weight functions of three performing securitisations which all share the same capital charge pre securitisation (i.e. K_{IRB}), but differ with respect to (p). Therefore, the part of the capital structure to be risk-weighted at 1250% is identical, while the remaining part of the risk weight function is determined by the respective (p) parameter:

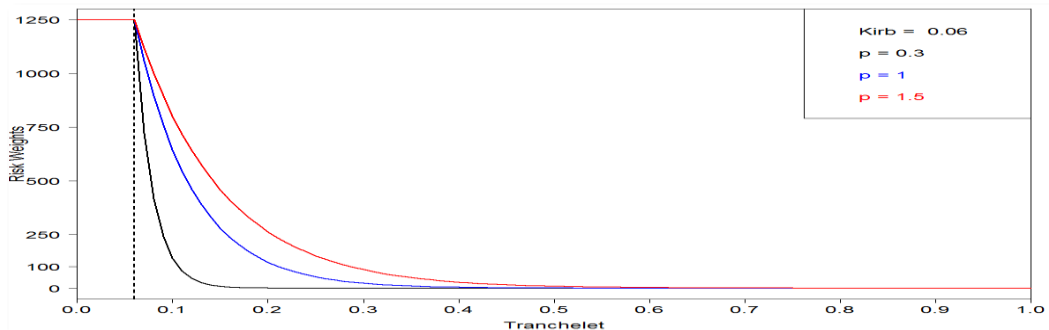


Figure 8. Source: Bundesbank and BaFin

In the case of NPE securitisations, the currently applicable (p) factor levels produce a very large increase in the capital requirements of the tranches compared to performing transactions because, as noted , the underlying pool's capital requirements on which (p) is applied are calculated on the basis of gross inputs and, as a result, are much higher than those of performing pools, against which (p) was initially calibrated. However, the impact varies greatly between the two SEC-IRBA approaches depending on whether supervisory or own calculated LGD levels are used, as shown in the following graph for two benchmark NPE securitisations:

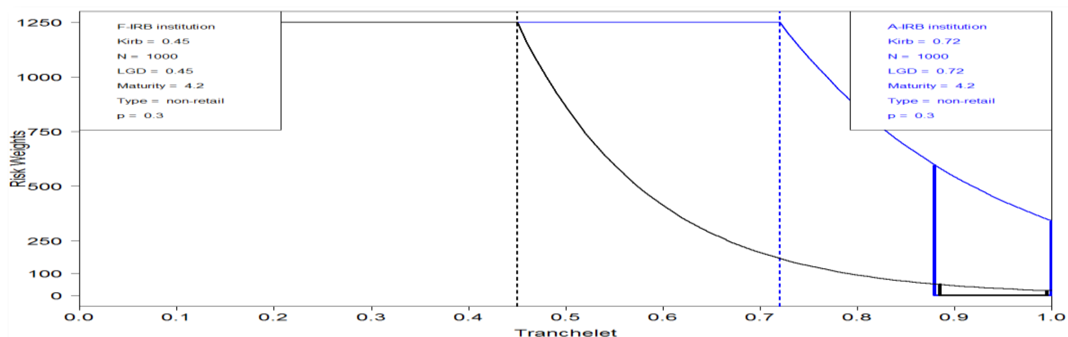


Figure 9. Source: Bundesbank and BaFin

Whilst the impact varies, the rationale for applying the same level of (p) to NPEs as for performing securitisations appears dubious, insofar as there is no need to model PDs (which are set at 100% for NPE pools from inception) and, thus, the model risk is greatly mitigated. Reflecting this rationale, Kirb is factored in as a negative input to the calculation formula of the (p) factor. Hence, the higher the Kirb on the underlying assets, the lower the capital surcharge of the tranches (Article 259(1) of the CRR). However, the 0.3 floor at which (p) is set for SEC-IRBA and the level applicable to the SEC-SA (1) appears excessively high for NPE securitisations.

d. Case study

The impact from the calibration of the SEC-methods on positions in an NPE-backed securitisation can be seen in the following Irish NPE securitisation[12]:

Figure 10

Standardised Approach (SEC-SA)	
Purchase Price Discount	79%
Delinquency	100%
Legal Maturity	5.00
	8%
Tranche Maturity (M)	5.00
Attachment (A)	91%
Detachment (D)	100%
Senior Tranche Risk Weight	**505%**
Max Senior Tranche Risk Weight (look-through)	**100% or 150%**

	Advanced IRBA (SEC-IRBA)	Foundation IRBA (SEC-IRBA)
Purchase Price Discount	79%	79%
Probability of Default (PD)	100%	100%
Effective LGD (ELGD)	72%	45%
Expected Loss best estimate (ELBe)	70%	45%
Legal Maturity	5.00	5.00
No-retail, Senior, Granular (N >= 25)		
KIRBR³	72%	45%
Tranche Maturity (M)	4.20	4.20
Attachment (A)	91%	91%
Detachment (D)	100%	100%
Senior Tranche Risk Weight	**426%**	**30%**

Class	Amount (EURmn)	Size NBV (%)	Ratings – Moody's	Ratings – DBRS	Size adjusted GVB (%)	Attach ment	SEC-ERBA RW	SEC-SA RW	Advanced SEC-IRBA RW	Foundation SEC-IRBA RW
A	182.76	43.50%	A1	A	9.14%	90.87%	63%	505%	426%	30%
B	16.81	4.00%	Baa3	BBB	0.84%	90.03%	136%	557%	532%	43%
C	14.71	3.50%	B1	BB	0.74%	89.29%	273%	566%	552%	46%
Other	205.87	49.00%	NR	NR	10.29%	79.00%		633%	719%	70%
NRPPD	1580.56				79.00%	0.00%				
GVB	2000.71				100.00%					

[12] Source: Deutsche Bank and EBA. ELGD and ELBe are assumptions for illustrative purposes. Portfolio's Kirb of 25% where the NRPPD offsets the best estimate of Expected Losses (EL) in accordance with Arts. 158 and 159 CRR, where EL ((max (ELBe – NRPPD, 0) + (LGD in default – ELBe)) x 12.5 = 0 + 2% x 12.5).

The SEC-ERBA is used as relevant benchmark for comparison with the SEC-SA and SEC-IRBA because the credit rating process pays better regard to the preeminent NPE securitisation risk drivers. Specifically, credit ratings comprise an in-depth assessment of the prospective cash-flow of each tranche, the level of protection afforded by the NRPPD and the servicing environment. Conversely, the SEC-IRBA and the SEC-SA rely on quantitative credit risk information from the underlying pool as if it was still performing (as discussed above).

The case study shows that:

i) the calibration of the advanced SEC-IRBA (own calculated LGD levels) (426% risk weight ("RW") for the senior tranche) and the SEC-SA (505% RW for the senior tranche) produces capital charges for all tranches greatly in excess of the capital that would be required under the SEC-ERBA (63% RW for the senior tranche) for the same tranches; and

ii) the foundation SEC-IRBA (supervisory LGD levels) has the opposite effect of overly lowering risk weights relative to the SEC-ERBA, most notably on the mezzanine (43% RW vs. 136% RW) and junior (46% RW vs. 273% RW) tranches. This is due to the mandatory RWs (45%) being significantly lower than the effective LGD levels (72%) applied under the advanced SEC-IRBA and the NPEs' NRPPD (79%). The use of supervisory LGD levels seems, in any event, inadequate where the portfolio loss levels have been subject to an external verification and assessed as higher, in this case as crystallised by the NRPPD.

2.2.2 The caps for securitisations (Arts. 267 and 268 of the CRR)

As noted under section 2.1, the caps for securitisations should serve as a safeguard against the overly conservative capital charges that may result from the securitisation methods (SEC-IRBA, SEC-SA and SEC-ERBA). The rationale for the caps is that the investor institution should be able to apply to the securitisation positions (the senior position in the case of the look-through approach) the same or substantially the same capital charges that it would apply to the underlying exposures if these "had not been securitised", that is, as if the investor had a direct exposure to the underlying. Therefore, the caps also ensure consistency with the non-securitisation framework.

As with the securitisation methods, the pre-eminent capital driver for the caps is the relevant credit risk method on the underlying, which in this case applies directly without taking into account the tranched structure of the securitisation (the effect of the attachment (A) and detachment points (D)).

a. Caps for securitisations under SEC-IRBA: calculation of RWEA based on gross vs. net inputs

Where an investor institution seeks to apply the look-through approach under the SEC-IRBA, paragraph (3) of Article 267 of the CRR provides that the calculation of the maximum risk-weight on the senior position must include, *inter alia*, the ratio of (i) *expected*

losses multiplied by 12.5; to (ii) the *exposure value* of the underlying exposures. Article 268(1) similarly provides that the IRB approach capital requirements for the purposes of the overall cap "shall include the amount of *expected losses* associated with those exposures calculated under Chapter 3".

The references to "expected losses" and "exposure value" therein may be read as gross amounts and, thus, requiring the investor institution to apply to the calculation of the cap the same grossed-up inputs as the originator in accordance with Chapter 3 of Title II of the CRR[13]. This interpretation would rely on the securitisation framework's implicitly referring back to the definition of "expected loss" in Article 5 (3) CRR. Expected losses are defined therein as the "ratio of the amount expected to be lost on an exposure from a potential default of a counterparty or dilution over a one-year period to the amount outstanding at default", which is calculated without netting the amount of SCRAs.

Where gross inputs are used, the resulting maximum risk weight for the look-through approach for the senior position of the NPE securitisation reviewed under section 2.2.1(d) is as follows:

Figure 11

Class	Amount (EUR mn)	Size NBV (%)	Size adjusted GVB (%)	Attach ment	SEC-ERBA RW[14]	SEC-SA RW	Advanced SEC-IRBA RW	Foundation SEC-IRBA RW	Max Senior Tranche RW (Look-through) A-IRB	Max Senior Tranche RW (Look-through) F-IRB
A	182.76	43.5%	9.14%	90.87%	63%	505%	426%	30%	**900%**	**563%**

These amounts for the maximum risk weight greatly exceed the risk weights under the securitisation methods and render the look-through approach unworkable as a proper safeguard.

However, as noted, the cap should enable the investor institution to have a hypothetical direct exposure to the underlying for regulatory capital calculation purposes. As the underlying exposures are held by the SPV from inception (when it acquired them), the investor institution should hold regulatory capital for the underlying portfolio's expected

[13] The originator applies the IRB capital inputs on a gross book value basis for UL (calculation of RWEAs), disregarding any SCRAs on the portfolio. However, the originator may calculate an IRB EL shortfall/excess on the exposure in accordance with Article 158 and Article 159 of the CRR. The originator may deduct the IRB EL shortfall (where SCRAs are below ELs) from its common equity tier 1 capital ("CET 1 Capital") (Art. 159 of the CRR) or account for an IRB excess (where SCRAs exceed ELs) as additional tier 2 capital up to 0.6% of its IRB capital requirements (Art. 62(d) of the CRR).

[14] Moody's: A1; DBRS: A

and unexpected losses (EL + UL) at that time and not as the underlying exposures were treated by the originator prior to the transfer.

Insofar as the transfer of the NPEs to the SPV at a discount should write off[15] all (or substantially all) expected losses in the portfolio and leave only a residual exposure (their net value) subject to the risk that recoveries may be insufficient to repay that residual exposure (unexpected losses), it would seem more appropriate to net the NPE portfolio's "expected losses" and "exposure value" by the NRPPD for the specific purposes of articles 267(3) and 268(1). This would be consistent with the accounting treatment of those exposures in the SPV's balance sheet, which uses the fair value of the NPEs, thus fully factoring in their NRPPD. This approach should, however, require that the NRPPD be sufficiently loss-absorbing and, hence, appropriately sized to capture all the underlying exposures' expected losses.

There are two possible net basis calculations of the caps, as shown in the example below for the look-through approach in a simple securitisation structure:

NPE portfolio
- GBV = 100
- EL = 90 (fully provisioned)
- Risk Weighted Exposure Amount (RWEA) = 5

Simple securitisation structure
- NRPPD = 90
- sold junior = 1
- retained senior = 9

Senior (retained): 9
Junior (sold): 1
NRPPD=EL: 90

Figure 12. Source: ECB

A. **Partial net basis calculation**: exclude ELs from the calculation of the risk weight and divide by the portfolio's gross exposure value

   – RWEA: 5 (Article 268(1))
   – RW = 5 / 100 = 5%
   – RWEA senior tranche[1] = 5% x 9 = 0.45

B. **Full net basis calculation**: exclude ELs from the calculation of the risk weight and divide by the portfolio's net exposure value

   – RWEA: 5 (Article 268(1))
   – RW = 5 / (100-90) = 50%
   – RWEA senior tranche = 50% x 9 = 4.5

[15] the treatment of write-offs is specified in EBA's Q&A 2014_1064, where it was provided that an institution should not include the write-off in the calculation of its SCRAs, and instead net the exposure value of the asset in the amount of the write-off in accordance with Article 166 of the CRR

The partial net basis calculation only nets the NPEs' NRPDD against the expected losses (numerator) and, as a result, leads to imprudently low capital charges on the senior NPE securitisation position because the caps override the 15% general risk weight floor. To counter this, a full net basis calculation needs to be used in both the numerator (expected losses) and denominator (exposure value) of the risk weight formula, as a result of which both the undershooting and overshooting of capital requirements are avoided and the caps allowed to operate as intended (as a safeguard).

This full net basis calculation should not be available for other asset classes or securitisations (see point (c)).

b. Caps for securitisations under SEC-SA: applicable risk weight

Under Article 127 of the CRR, the risk weight on exposures in default held by an institution under the SA varies depending on whether the institution has applied SCRAs on those exposures in an amount of less than 20% of the unsecured part of the exposure (in which case the applicable risk weight is 150%), or that amount exceeds 20% (in which case, the applicable risk weight is 100%).

Where the defaulted exposures have been securitised and the investor institutions seeks to apply the caps for securitisations under the SEC-SA, Article 127 should be read in conjunction with Articles 267 and 268 to determine the applicable risk weight. Accordingly, the investor institution would apply a 100% risk weight for the purposes of the caps where the originator was permitted to use that same risk weight on the portfolio pre-securitisation in accordance with Article 127 and the amount of NRPPD is at least equal to or larger than the SCRAs made by the originator.

c. Caps for securitisations for performing assets securitised below par

It should be noted that the issues for the caps for securitisations described under this section derive from the discount on the nominal value of the underlying assets where these are securitised below par. Therefore, they are not exclusive to NPEs, though the impact on these is typically more pronounced due to the much larger size of the NRPPD in these transactions than in other asset classes or transactions.

However, the full net basis interpretation referred to under point (a) and the use of a 100% risk weight referred to under point (b) are linked to credit risk losses and credit risk adjustments. The matters described in this opinion are only relevant for NPE securitisations and the proposals herein should not be read as applicable to performing assets securitised below par.

2.2.3 Regulatory capital impact and level playing field issues

The comparatively high capital requirements in most of the scenarios reviewed above render the framework very capital intensive for institutions wishing to invest in NPE securitisations, in particular in the senior tranches. The RoE for these under the above assumptions (1.5-4.5%) would materially underperform European banks equity (RoE targets of >10%). To achieve a 10% RoE, the margin on NPE transactions senior tranche would have to more than double (e.g. 6.8% under SEC-SA).

Moreover, the EU securitisation capital framework inadvertently favours institutions from third countries which have failed to implement the Basel framework. Institutions with their head office in those third countries are not subject to the EU securitisation framework or to similar requirements and, therefore, can invest in EU-originated NPE securitisations without facing the same regulatory constraints of their European peers.

Higher funding costs lead to higher price discounts and, as a result, losses for the originator, making securitisations unattractive as an NPE disposal tool for EU institutions and uncompetitive relative to international peers.

2.3 Opinion to the European Commission on the treatment of NPE securitisations in the CRR

2.3.1 Calibration of the securitisation regulatory capital methods for NPE securitisations

- It is the EBA's opinion that the regulatory capital calibration for securitisations, as currently laid down in the CRR, should be reassessed to address the technical shortcomings on NPE securitisations referred to in this opinion.
- The EBA, therefore, recommends the European Commission to consider the merits of reviewing the CRR in relation to the following:

  a) the scope of "NPE securitisations" and including, in particular, a requirement that the securitised pool comprise a mandatory minimum level of NPEs from origination;

  b) the desirable level of the (p) factor for NPE securitisations for the purposes of Articles 259(1) and 261(1) of the CRR;

  c) the inputs to the formulaic approaches (SEC-IRBA and SEC-SA) to better reflect the loss-absorbing effect of the NRPPD in NPE securitisations;

  d) using within the securitisation framework the net book value approach when determining attachment (A) and detachment (D) points for the setting of capital requirements for NPE securitisations; and/or

e) an appropriate prudential treatment for pools of securitised exposures comprising both performing and non-performing exposures ("mixed pools") for the purposes of the securitisation framework.

- Without prejudice to a thorough assessment of all possible alternatives, the EBA's view is that any amendments to the calibration in the CRR to deal with NPE securitisations-specific issues should seek to deliver as quickly as possible a resolution to the issues referred to in this opinion, while maintaining the integrity and consistency of the current securitisation framework. Thus, the preferred option should be capable of being applied to (i) both NPEs and performing assets; (ii) purchase price discounts and SCRAs; (iii) all securitisation tranches from first loss to senior; (iv) all institutions, whether using the SEC-SA or the SEC-IRBA; and (v) at all times, from issuance to maturity. One such option consistent with these principles would be to adjust the current (p) factor down from current levels (0.3 floor for SEC-IRBA and 1 for SEC-SA) where the portfolio's loss levels increase. Furthermore, any instances of undercalibration should be prevented at the same time.

2.3.2 Caps for NPE securitisations

- The EBA is of the opinion that a "full net basis calculation" should be the preferred approach for the purposes of applying the caps under the SEC-IRBA to NPE securitisations. This approach enables the caps to meet their intended purpose as a safeguard against unduly high capital requirements.

- Where the SEC-SA applies, it is the EBA's opinion that the investor institution should be able to apply a 100% risk weight for the caps for securitisations where the originator was permitted to apply this same risk weight on the underlying portfolio in accordance with Article 127 of the CRR and the amount of NRPPD is equal to or larger than the SCRAs made by the originator as set out in that Article.

- The EBA, therefore, recommends the European Commission to take action to clarify that, in relation to the caps for securitisations laid down in Articles 267 and 268 of the CRR:

  a) where NPEs are securitised, the "expected losses" and "exposure value" referred to in paragraph (3) of Article 267 and paragraph (1) of Article 268 under the SEC-IRBA should be calculated net of the NRPPDs and, where applicable in the case of the originating institution, additional SCRAs;

  b) where NPEs are securitised, the applicable risk weight for SEC-SA purposes should be 100% where the originator was able to apply that same risk weight on the underlying portfolio pre-securitisation in accordance with Article 127 of the CRR and the NRPPD exceeds the percentage of SCRAs made by the originator as set out in that Article; and

  c) the matters referred to in points (a) and (b) do not apply to assets securitised below par due to reasons other than credit losses on them.

- Subject to the outcome of the review referred to in the preceding paragraph, it is also recommended that the European Commission consider the convenience of amending Article 267 of the CRR to provide that the capital floor in Articles 259(1) and 261(1) of the CRR applies to the look-through approach for the purposes of NPE securitisations.

- As the matters referred to in the preceding paragraphs would require defining a class of “NPE securitisations”, we refer to the overarching definition that could result from the assessment referred to in section 2.3.1 and which could apply to the caps as well. The treatment of “mixed pools”, as referred to in that same section, should also be considered as regards the application of the caps.

- The EBA advises the European Commission to take account of any developments in the Basel Committee on the matters referred to under this section for the purpose of implementing the recommendations laid down herein.

3. The Securitisation Regulation

3.1 Background

The Securitisation Regulation sets out the substantive legal framework applicable to all securitisations in the EU and introduces rules for issuing simple, transparent and standardised ("STS") transactions. These may not comprise defaulted assets and, accordingly, NPE securitisations are prevented from qualifying as STS.

NPE securitisations are, however, subject to other rules of general application, which must be viewed and interpreted against the Securitisation Regulation's chief objective to help bring back this market on sound and prudent basis, crucially by preventing a recurrence of the circumstances that led to the 2008 financial crisis.

For the purposes of this opinion, the following two requirements of general application need to be singled out:

- risk retention: the transaction's originator, sponsor or original lender is required to retain on an ongoing basis a minimum level of material net economic interest in the securitised portfolio. The purpose of this requirement is to provide for appropriate alignment of interests between originators and investors in a securitisation; and
- due diligence / verification duties: securitisations are subject to mandatory due diligence, namely on institutional investors prior to investing, but also on originators acquiring portfolios of assets which they subsequently securitise. The latter requirements on originators are specifically aimed at constraining the "originate-to distribute" model.

The overarching objective of the Securitisation Regulation remains certainly relevant for and applicable to NPE transactions. However, the design of some of these requirements, as further explained below, gives rise to compliance difficulties due to the framework's not taking into account the specific features of NPE securitisations.

3.2 Risk retention

Article 6(1) of the Securitisation Regulation provides that "the originator, sponsor or original lender of a securitisation shall retain on an ongoing basis a material net economic interest in the securitisation of not less than 5%". As said, this requirement is intended to ensure an appropriate alignment of interests between originators (sponsors or original lenders) and investors in a securitisation.

Whilst it is appropriate for the risk retention requirement to apply to NPE securitisations, participants in these transactions encounter compliance difficulties in relation to: (i) the determination of the retention amount based on "nominal values" of the underlying assets; and

(ii) the range of potential parties obliged to retain being restricted to either the originator, the sponsor and/or the original lender, whose interest is not always the most closely aligned to that of the investors in the NPE transaction.

3.2.1 Nominal values vs. purchase price

There are five permitted methods to meet this requirement as per Article 6(3) of the Securitisation Regulation:

- the retention of not less than 5% of the nominal value of the tranches sold to investors;
- in the case of revolving securitisations or securitisations of revolving exposures, the retention of not less than 5% of the nominal value of the securitised exposures;
- the retention of randomly selected exposures equal to not less than 5% of the nominal value of the securitised exposures;
- the retention of the first loss tranche, provided that in that case the retained amount is at least 5% of the nominal value of the securitised exposures; or
- the retention of a first loss exposure of not less than 5% of every securitised exposure in the securitisation.

Whilst the Securitisation Regulation falls short of defining the 5% in the last method as "nominal value", Article 9(2) [16] of Delegated Regulation 575/2013 (the "Delegated Regulation") implementing this method does so. More concretely, this form of retention may be met by selling the underlying exposures at a discounted value of not less than 5% of the nominal value of each exposure, provided that that the discount is refundable to the originator or original lender.

Lastly, Article 10(1)(b) of Delegated Regulation 575/2013 provides that "the calculation of the level of retention shall be based on nominal values and the acquisition price of the assets shall not be taken into account"[17].

Using the NPEs' nominal value for risk retention purposes disregards the NRPPD at which the underlying assets are sold to the SPV and leads to overstating the amount of the retention requirement, as shown in the following example:

[16] See Art. 9 of draft Regulation (EU) 2017/2402 (in the version adopted by the EBA), that will in due course repeal and replace Delegated Regulation 575/2013. Both provisions are substantially the same

[17] See Art. 10(1)(b) of draft Regulation (EU) 2017/2402 (in the version adopted by the EBA), that will in due course repeal and replace Delegated Regulation 575/2013. Both provisions are substantially the same

Figure 13

Numerical example:		Actual loss risk of investors	EUR 10mn
Original principal amount	EUR 100mn	**Retention amount?**	
Purchased price	EUR 10mn		
		5% of EUR 10mn	EUR 0.5mn
2 tranches			
Junior tranche nominal	EUR 1 mn	Or	
Senior tranche nominal	EUR 9 mn		
		5% of EUR 100mn	EUR 5mn
Originator retains junior tranche			

The 5% becomes a 50% retention amount on the actual loss risk when the first loss exposure retention option is followed, which does not seem consistent with the economics of the transaction and constrains the flexibility for the parties involved in originating and structuring NPE securitisations.

The requirement in Article 10(1)(b) of the Delegated Regulation to disregard the “acquisition price of the assets” could likewise be interpreted as referring to the NRPPD in NPE securitisations.

Furthermore, the methods using the nominal value of the securitisation tranches do not provide sufficient flexibility and, therefore, may not provide a workable alternative for NPEs. As the retention amount is not calculated by reference to the first loss piece, a vertical slice needs to be held to meet the requirement. NPE investors, however, tend to prefer that the servicer retain a percentage of the first loss piece as more suitable to show “skin in the game” (see section 3.2.2).

For securitisations where the assets are securitised below par but the NRPPD on the nominal value of the securitised assets is due to reasons other than credit risk losses on the underlying, the nominal value remains appropriate for calculating the retention amount and, accordingly, the concern described in this section is not relevant.

3.2.2 Party obliged to retain

In “performing” securitisations the prevalent interest is that of the originator, which is, in many cases, the original lender as well. The originator will sell the assets to raise funding but the borrowers will often remain unaware, as the originator will retain the servicing to prevent disruption to customer relations. Hence, the originator’s interest is that the assets continue performing as if they had not been securitised and, as a result, it is perfectly aligned with the investors’ interest.

In NPE financings, by contrast, the originator seeks first and foremost to offload defaulted assets that weigh on its balance sheet and may want to detach itself completely from them if there is no longer an ongoing customer relation to preserve. Furthermore and given the specific features

of this market examined before, the NPEs tend to be sold to intermediate parties and then securitised, so the original lender is often not involved in the securitisation.

Unlike the originator/original lender, other parties will have the more prevalent interest in the successful workout of the assets, along with the investors.

In many cases, the specialist third party that purchased the NPEs, typically a hedge fund, private equity fund or investment bank, will meet the definition of "originator" or "sponsor" as per Article 2 of the Securitisation Regulation. However, these parties may sometimes perform a purely advisory, structuring and/or interim financing role only and will step out after the transaction is completed. In these cases, the more prevalent interest in the successful workout of the assets is that of the servicer.

The servicing of the NPEs is typically contracted out to an independent servicer on whose performance rests the successful workout of the assets. Crucially, the servicer may retain the mezzanine and/or junior tranche and its fees will normally be payable out of the collections from the assets as part of the securitisation's payment waterfall. Whilst it can be argued that in such cases the servicer has "skin in the game", it will fail to meet the definition of "sponsor" as per Article 2(5) of the Securitisation Regulation and, as a result, it may not legally discharge the risk retention requirement. The servicer does not meet the legal definitions of originator or sponsor because:

- as regards the definition of "originator" (Article 2(3) of the Securitisation Regulation), the servicer was not involved in the "original agreement which created" the exposures and does not normally purchase the assets from the originator "on its own account" with a view to securitising them; and
- as regards the definition of "sponsor" (Article 2 (5) of the Securitisation Regulation), the servicer is neither a "credit institution" nor an "investment firm".

3.3 Due diligence: verification of acquired portfolios

Under Article 9(3) of the Securitisation Regulation, originators that purchase a third party's exposures for their own account and then securitise them are obliged to:

- "verify" that the entity which was directly or indirectly involved in the original agreement which created the obligations or potential obligations to be securitised complied with paragraph (1); and
- as per that paragraph (1), verify that the securitised exposures were subject to the same "sound and well defined criteria for credit granting" applied by the originator, original lender or sponsor to non-securitised exposures.

As with the risk retention requirement, the aim of this verification duty in Article 9 is to protect against the risks of the "originate to distribute" model whereby originators, original lenders and/or

sponsors create and select assets of lesser quality for securitisation and transfer the risks to less knowledgeable investors. While the overarching principle remains appropriate for NPE securitisations, the concrete terms of the requirement are problematic as it cannot be said that "sound and well defined credit granting criteria" were applied where NPEs are involved without taking into account the specific circumstances of the purchase of the assets and the type of securitisation.

Further, this requirement may be challenging not only for NPEs but also for certain other securitisations with third party originated assets. For instance, the assets to be securitised may have been transferred multiple times since their creation or be old enough that the relevant information for the comparison required under Article 9(1) has not been retained for legitimate reasons.

In all of these cases, both for NPEs and certain other securitisations, it may not be possible to gain certainty around the circumstances in which the assets were created, but it is nonetheless possible to carry out a due diligence on the quality and performance of the assets in order to make a sensible, well-informed investment decision.

3.4 Opinion to the European Commission on the treatment NPE securitisations in the Securitisation Regulation

The EBA considers that the risk retention and due diligence requirements laid down in the Securitisation Regulation and as specifically referred to in sections 3.2 and 3.3 do not take due account of certain particular features of NPE securitisations and lead to compliance issues for participants in this market.

Hence, the EBA advises the European Commission to consider the convenience of reviewing the Securitisation Regulation to provide:

- as regards the risk retention requirement in Article 6 of the Securitisation Regulation and related provisions in the Delegated Regulation:
  - a) a specific risk retention amount calculation method for NPE securitisations that takes into account the NRPPD on the assets' nominal value. If considered appropriate, the Commission could seek to amend the Delegated Regulation for one of the methods, but it may be more appropriate to deal with this matter at the level of the Securitisation Regulation in order to ensure consistency between all the applicable retention methods;
  - b) that the independent servicer be entitled to discharge the retention obligation where its interests in the successful workout of the assets are appropriately aligned with those of the investors in the bonds ("skin in the game");
- a specific treatment for NPE securitisations and certain other securitisations with third party originated assets as regards the obligation to verify that the originator or original lender applied "sound and well defined credit granting criteria" as laid down in Article 9(1) and (3) of the Securitisation Regulation.