HERBERT SMITH FREEHILLS

NPL SECTOR - KEY CHANGES TO THE EU SECURITISATION REGULATION AND CRR

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Legal Briefings

SECURITISATION REGULATION: UNFINISHED BUSINESS FOR NPL AND SYNTHETIC SECURITISATIONS

Regulation (EU) No 2017/2402 of the European Parliament and of the Council of 12 December 2017 "laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation" (the "Securitisation Regulation") has been in force since 2019. The aim of the Securitisation Regulation is to (i) implement a general framework for all securitisations and (ii) create a simple, transparent and standardised label (known as "STS label") to allow a favourable prudential treatment for regulated investors. The issues tackled by the Securitisation Regulation are complex and require adjustments to achieve its goal: facilitating the refinancing of the economy through securitisations.

In some respects, one may consider that the Securitisation Regulation is still unfinished business. Many market participants have been hoping and anticipating since the Securitisation Regulation came into force that adjustments would be made for certain categories of transactions, in particular:

(i) tailoring provisions of the Securitisation Regulation for non-performing exposures securitisations (in particular in respect of risk retention requirements); and

(ii) the availability of an STS label treatment for synthetic securitisations further to a publication by the European Banking Authority (the "EBA") of its proposals for developing an STS framework for synthetic securitisation on 6 May 2020 1.

TWO KEY EU REGULATIONS HAVE BEEN PUBLISHED TO FACILITATE NPL AND SYNTHETIC SECURITISATIONS

In order to implement the adjustments required to cater for the above-mentioned categories of transactions, two EU regulations were published on 31 March 2021:

(i) Regulation (EU) 2021/557 of 31 March 2021 amending the Securitisation Regulation (the "SR Amendment"); and

(ii) Regulation (EU) 2021/558 of 31 March 2021 amending the CRR (the "CRR Amendment").

The purpose of the SR Regulation Amendment is to:

(i) remove obstacles to the securitisation of NPL transactions (without, however, allowing NPL transactions to be STS); and

(ii) extend the STS securitisation framework to synthetic securitisation.

The CRR Amendment is, broadly speaking, the prudential mirror in the CRR of the provisions set out in the SR Amendment. Both the SR Amendment and the CRR Amendment entered into force on 9 April 2021 (except for some technical provisions).

This paper focuses on NPL transactions (called non-performing exposures securitisations or "NPE" securitisations in the SR Amendment).

WHAT IS AN "NPE SECURITISATION"?

NPL transactions are referred as "NPE (i.e. non-performing exposures) securitisations" in the SR Amendment. The SR Amendment specifies that NPE securitisations are transactions backed by pools comprised exclusively or almost exclusively of non-performing exposures at the time of inception, i.e. not less than 90 % of the entire pool's nominal value at the time of origination (here meaning the point at which the transaction is established).

The SR Amendment provides a quite wide definition of "non-performing exposures"(herein referred to as NPE). It cross refers to article 47(a)(3) of the CRR which provides that "(...) the following exposures shall be classified as non-performing: (a) an exposure in respect of which a default is considered to have occurred in accordance with Article 178 [i.e. broadly more than 90 days past due or unlikely to be paid]; (b) an exposure which is considered to be impaired in accordance with the applicable accounting framework; (c) an exposure under probation, where additional forbearance measures are granted or where the exposure becomes more than 30 days past due; (d) an exposure in the form of a commitment that, were it drawn down or otherwise used, would likely not be paid back in full without realisation of collateral; (e) an exposure in form of a financial guarantee that is likely to be called by the guaranteed party, including where the underlying guaranteed exposure meets the criteria to be considered as non-performing."

A NEW RISK RETENTION REGIME FOR NPE SECURITISATIONS2

As emphasized by the EU legislative work surrounding the SR Amendment,3 "The key difference between many securitisations and non-performing loan securitisations lies in the nature of the underlying assets: while the assets in most securitisations generate (at least in theory) stable and predictable cash flows, the collection of which is straightforward, the assets underpinning non-performing loans are anything but stable and predictable. For this reason, it is the servicer that must take active steps to resolve the NPEs and generate a cash flow".

A- Role of the Servicer

The foregoing explains the main change: NPL servicers will now be able to be an eligible retainer in NPE securitisations as clearly set out in the SR Amendment: "In the case of traditional NPE securitisations, the [retention risk] requirement of this paragraph may also be fulfilled by the servicer provided that the servicer can demonstrate that it has expertise in servicing exposures of a similar nature to those securitised and that it has well-documented and adequate policies, procedures and risk-management controls in place relating to the servicing of exposures".

In NPE securitisations, the seller of the NPLs may be the originator that has originated the underlying exposures as a "limb (a)" originator within the context of the Securitisation Regulation, or it may be an entity that has previously acquired the pool (a "limb (b)" originator within the context of the Securitisation Regulation see below). Sellers of NPE generally wish to remove the NPE from the balance sheet and therefore cannot retain any risk. It therefore cannot be the eligible retainer that will carry out the retention required under the Securitisation Regulation.

In practice, NPE securitisations are often driven by professional servicers or fund vehicles that are not credit institutions or investment firms. This excludes them from the possibility of being an eligible retainer as sponsor. To be an eligible retainer, the possibility must remain for such participants to qualify as a "limb (b)" originator, i.e. "an entity that purchases a third party's exposures on its own account and then securitises them". This may have its own challenges however, particularly where the investment is made through a newly created vehicle.

The possibility for servicers to act as an eligible retainer will be very relevant for professional servicers leading the arrangement of NPE securitisations which, in France, is often the case. It may however be less useful if the entity behind the arrangement of NPE securitisations is not a professional servicer but rather a fund, as in the absence of an external servicer, the selling entity of an NPL portfolio will generally not accept the role of retention holder even if it acts as servicer on a temporary basis. In such a case, the "limb (b)" originator approach is likely to be followed.

B - Nominal value vs net value in the context of risk retention of NPE securitisations

The SR Amendment creates a new sub-paragraph in article 6 of the Securitisation Regulation which provides that the "economic interest for the purposes of [NPE securitisations] shall not be less than 5 % of the sum of the net value [i.e. not the nominal value] of the securitised exposures that qualify as non-performing exposures.".

This means that the amount to be retained by the eligible retainer in the context of NPE securitisations shall be determined on the basis of the discounted value of the securitised exposures in contrast to their nominal value (as the nominal value does not reflect the "real" value of the exposures, even at the inception of the transaction). Preamble (8) of the SR Amendment summarises this perfectly: "The assets backing NPE securitisations are economically distinct from those of securitisations of performing assets. NPEs are securitised at a discount on their nominal or outstanding value and reflect the market's assessment of, inter alia, the likelihood of the debt workout generating sufficient cash flow and asset recovery. The risk for investors is, therefore, that the debt workout for the assets does not generate sufficient cash flow and asset recovery to cover the net value at which the NPEs have been purchased. The actual risk of loss for investors does, therefore, not represent the nominal value of the portfolio, but the discounted value, namely, net of the price discount at which the underlying assets are transferred. It is therefore appropriate, in the case of NPE securitisations, to calculate the amount of the risk retention on the basis of that discounted value". Note that the net value of a non-performing exposure excludes refundable purchase price discounts. Otherwise, this could undermine the risk transfer as the originator is still exposed to the performance of the nonperforming exposures.

NO STS LABEL FOR NPE SECURITISATIONS

The STS label is not available for NPE transactions. The Securitisation Regulation did not derogate from this principle and the following STS criterion still apply (both for ABCP and non-ABCP transactions) "The underlying exposures shall be transferred to the SSPE after selection without undue delay and shall not include, at the time of selection, exposures in default within the meaning of Article 178(1) of Regulation (EU) No 575/2013 or exposures to a credit-impaired debtor or guarantor".

CREDIT GRANTING REQUIREMENTS

As a reminder, the purpose of article 5 of the Securitisation Regulation is to require investors to check that the originator used the same sound and well-defined criteria for credit-granting that they apply to nonsecuritised exposures. This proved somewhat counter-intuitive in the context of NPE transactions. As emphasized by preamble (10) of the SR Amendment, "For NPE securitisations, however, the credit granting standards applicable at the origination of the securitised assets are of minor importance due to the specific circumstances including the purchase of those non-performing assets and the type of securitisation. Instead, the application of sound standards in the selection and pricing of the exposures is a more important factor with respect to investments in NPE securitisations".

As a result, the SR Amendment specifies that "Prior to holding a securitisation position, an institutional investor, other than the originator, sponsor or original lender, shall verify that "in the case of non-performing exposures, sound standards are applied in the selection and pricing of the exposures". This excludes the checking by investors of credit-granting to the NPE.

In the same vein, article 9.1 of the Securitisation Regulation provides that where a "limb (b)" originator purchases a third party's exposures and subsequently securitises them, such "limb (b)" originator shall verify that the entity that was, directly or indirectly, involved in the original agreement, applies the same sound and well-defined criteria for credit-granting to exposures to be securitised as they would to non-securitised exposures. Again, this has been debated for NPE securitisations. The EBA chose not to take a stance on this, although the issue was clearly raised by market participants4. The SR Amendment now provides that "By way of derogation from [article 9.1], with regard to underlying exposures that were non-performing exposures at the time the originator purchased them from the relevant third party, sound standards shall apply in the selection and pricing of the exposures". As with article 5, emphasis is now put on the selection of exposures in NPE transactions, rather than on credit granting.

CRR AMENDMENT AND IMPACT ON NPE SECURITISATIONS

The CRR Amendment creates a new article 269a of the CRR entitled "treatment of non-performing exposures securitisations". The purpose of this article is to specify how the risk weight for a position in an NPE securitisation will be calculated. In a nutshell, the purpose of this new article is to confirm that all tranches of NPE securitisations, except the senior tranche, would be subject to a flat risk weight of 100 % provided that the exposures in the pool backing the securitisation had been transferred to the SSPE with a non-refundable price discount of at least 50 % on the nominal amount of the exposures.

Another important feature is that the CRR Amendment also provides that "expected losses associated with exposures underlying a qualifying traditional NPE securitisation shall be included after deduction of the nonrefundable purchase price discount and, where applicable, any additional specific credit risk adjustments". In other terms, expected losses and exposure values in respect of the NPE portfolio can be calculated net of the non-refundable purchase price discount, which is an attractive treatment.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

VINCENT HATTON
PARTNER, PARIS

+33 1 53 57 70 85
vincent.hatton@hsf.com

JOY AMIS
PARTNER, LONDON

+44 20 7466 2840
Joy.Amis@hsf.com

MICHAEL POULTON
PARTNER, LONDON

+44 20 7466 2777
michael.poulton@hsf.com

BEATRIZ DEL REY
OF COUNSEL (SPAIN), LONDON
+44 20 7466 2912
Beatriz.DelRey@hsf.com

JAKE JACKAMAN
PARTNER, LONDON

+44 20 7466 2883
Jake.Jackaman@hsf.com

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