afme/ Finance for Europe

UK FINANCE

26 July 2021

Securitisation Policy
Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

Submitted by email: CP10_21@bankofengland.co.uk

Re: CP10/21 on Implementation of Basel standards: Non-performing loan securitisations

On behalf of the Association for Financial Markets in Europe ("**AFME**")[1], UK Finance[2] (together with AFME, the "**Joint Associations**") and their members, we welcome the opportunity to respond to CP10/21 on the implementation of Basel standards: non-performing loan securitisations (the "**CP**") published by the Prudential Regulation Authority (the "**PRA**") and dated June 2021.

Over the last several years there has been a significant and increasing use of securitisation techniques to help reduce the volume of non-performing exposures ("**NPEs**") on the balance sheets of firms, especially in Europe (including the UK) where the market has been most active. That market activity has highlighted the difficulties associated with applying the securitisation regulatory scheme (and especially the capital rules) to securitisations of NPEs in an appropriate way that produces sensible and risk-sensitive results. The Joint Associations are encouraged to see the PRA acknowledge the need to revise this.

The members of the Joint Associations have considered these issues carefully, many of them having responded either directly or via a trade association to the Basel consultation on the Technical Amendment the implementation of which the PRA is now consulting on in the CP. As a general matter, the members of the Joint Associations were disappointed with the lack of risk sensitivity in the amendments proposed by the Basel Committee. The Technical Amendment may reflect an appropriate position for some jurisdictions represented on the Basel Committee on Banking Supervision, but we do not believe it is appropriate for the UK markets.

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[1] AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 6511006398676.

[2] UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms, we act to enhance competitiveness, support customers and facilitate innovation.

We are therefore encouraged by the PRA's openness to evidence that a straightforward transposition of the standards established at the Basel level might not be appropriate in the UK. In particular, the Joint Associations are of the view that both the fixed risk weight of 100% for qualifying senior tranches and the 100% risk-weight floor for exposures to NPE securitisations are insufficiently risk-sensitive and should be re-examined for application in a UK context.

Further, we do not believe there to be a valid rationale for oversight from the Senior Management Function of NPE securitisations under this new regime as required under the proposed new para. 2.5A of SS10/18, and believe it would add further complexity to an already vast and wide-ranging set of rules. It is not clear to members of the Joint Associations exactly what scenarios/risks this proposal is seeking to address. Given the relatively small size of the UK NPE securitisation market at present and the potential impact the new rules are trying to have, an alternative would be for the PRA to instead perform a review of the new framework after a specified period of time (say, three years), to see if any such concerns do materialise.

The final issue we would mention by way of introduction before going on to our detailed views on the proposals is that the definition of an "NPE" in general is appropriate, but it does mean that the proposals in the CP are limited to addressing those loans which are currently non-performing, or – in market parlance – unlikely to pay (since these would generally meet the legal standard for non-performing). However, there will be similar issues concerning the capital requirements in relation to e.g. reperforming loans that ideally would be addressed but are beyond the scope of the present proposals. Should the PRA wish to discuss these issues further we would be delighted to do so.

Detailed Responses to the proposals

Our views on the proposals may be summarised, in brief, as follows:

1. The scope of the proposals is, in our view, too narrow. For NPE securitisations to be meaningfully facilitated, the adjustments need to be broader and encompass rules included in the Securitisation Regulation – especially the risk retention rules.

2. We do not believe that the 100% risk-weight floor for exposures to NPE securitisations (when using SEC-IRBA or SEC-SA) is appropriate. As with SEC-ERBA, both SEC-IRBA and SEC-SA are conservatively calibrated and the full credit-enhancing effect of NRPPD should be recognised, even where it causes risk weights to drop below 100%.

3. We do not believe it is appropriate to set a fixed risk-weight of 100% for senior exposures to qualifying NPE securitisations; we believe that this should be a ceiling instead. We also believe it is inappropriate to set the minimum NRPPD for a "qualifying NPE securitisation" at 50%; we would suggest 20% is a more appropriate figure.

4. The proposed definition of an "NPE securitisation" is too broad and uncertain. It should be amended to ensure that firms have certainty about when a portfolio needs to be re-tested to check it remains an NPE securitisation.

5. On a separate point related to the subject of NPE securitisation, the Joint Associations would be grateful for confirmation from the PRA that NPEs securitised may be excluded from the prudential backstop in Article 36(1)(m) of the CRR (the "NPE Backstop") introduced in April 2019 by Regulation (EU) 2019/630.

We expand on each of these points below.

1. The scope of the proposals is too narrow and should include amendments to the Securitisation Regulation.

As we understand it, the policy underlying the proposals in the CP is to facilitate the securitisation of NPEs as a method of reducing the burden of NPEs on the balance sheets of firms. While a more risk-sensitive set of capital calibrations is a key element of this, it is not sufficient on its own. The Securitisation Regulation also contains barriers to the securitisation of NPEs, notably in the risk retention rules (Article 6), but there are also issues in the credit granting criteria verification rules (Article 9) and the due diligence rules (Article 5) that should be addressed.

Four out of the five permitted methods for risk retention under the Securitisation Regulation calculate the amount of the retention by reference to the nominal amount of the underlying securitised exposures, regardless of the amount paid by the securitisation vehicle to acquire those exposures from their originator(s). In the case of an NPE securitisation with a significant NRPPD, this is clearly inappropriate and inefficient, and can make otherwise viable NPE securitisations uneconomic.

Consider the example of an NPE securitisation where a portfolio with a nominal amount of 100 is sold into the securitisation with an NRPPD of 90%. If the originator does first loss (option (d)) retention, it would have to hold retention of 5 – being 5% of the nominal amount but 50% of the value paid for the portfolio. If, on the other hand, the originator used vertical retention (which is the only method where retention is calculated based on the value of the liabilities issued by the securitisation vehicle) the retention would be sized at 0.5 (being 5% of 10). The latter is clearly the more appropriate sizing of retention in a scenario where only 10 of cash is being raised against the portfolio, and should be permitted for all 5 retention methods, not just vertical retention. The choice of retention method is driven by a number of commercial factors and market participants should not be restricted to vertical retention for NPE securitisations by what is commonly acknowledged to be a historical accident of drafting.

The Joint Associations would also recommend that special servicers be added as an eligible retainer in respect of NPE securitisations. Unlike most securitisations of performing exposures, on NPE securitisations the skill and diligence with which special servicers work out an NPE portfolio play a significant role in determining the returns on the underlying exposures. A special servicer will often be the entity in the structure who knows the exposures best and has most direct control over the success of the workout. It is also common for the compensation of the special servicer to be based in large part on the proceeds of the workout[3]. For all of these reasons a special servicer is an obvious

[3] Which, for the avoidance of doubt, should not be precluded by the anti-avoidance provisions of the NRPPD definition where the originator is also the servicer and the fee is paid at a reasonable commercial rate.

candidate to hold the risk retention, since having its interests aligned with those of investors is an important factor in producing good outcomes for investors.

A further adaptation of the current framework that would be helpful would be to amend the onshored version of Delegated Regulation (EU) No 183/2014 to allow write-downs accounted for in the acquisition price of an exposure to be recognised by a CRR firm buying that exposure, so that the buyer firm could treat that discount as a specific credit risk adjustment for the purposes of Article 127(1) CRR.

2. ***The higher risk weight floor of 100% specific to NPE securitisations is not sufficiently risk sensitive and should be eliminated for SEC-IRBA and SEC-SA.***

The members of the Joint Associations strongly oppose this aspect of the CP. It would appear to achieve the opposite of the policy goal to encourage risk-sensitivity in the risk weighting of NPE securitisation exposures in that it is not correlated with the real risk profile of the relevant tranche.

The imposition of a 100% risk weight floor also seems to us to be overly conservative, as it would mean that a senior tranche of an NPE securitisation would frequently have the same risk weight as the underlying assets despite the securitisation structure adding significant liquidity and credit enhancement. Rather than encourage the securitisation of NPEs, this would discourage it.

A particularly clear example of a disproportionate outcome would be a securitisation in which the pool comprises both NPEs and the benefit of a post COVID-19 sovereign guarantee (on a *pro rata* basis) in respect of those NPEs. Such structures are technically possible[4] (and presumably prudentially welcome), but unlikely to be attractive if they generate a minimum 100% risk weight for noteholders where a direct exposure to the guarantor would likely be 0%. This is because existence of the government guarantee as credit protection does not affect whether the loan is "performing" for purposes of Article 47a(3) of the CRR and the NPE securitisation definition (this is clear from e.g. Article 47c of the CRR which prescribes different levels of deduction within the NPE Backstop for non-performing exposures subject to credit protection). Hence the existence of these government guarantees in relation to the underlying assets would not impact the application of the 100% risk weight floor to the resulting securitisation position in the rules as proposed.

As indicated above, in addition to credit protection on the underlying assets, the credit enhancement represented by subordinated junior and mezzanine tranches in a securitisation structure is a reason why senior tranches in the securitisation generally expect to achieve risk weights that are lower than a direct exposure to the underlying

[4] Basel explicitly states that the K_{SA} calculation "should reflect the effects of any credit risk mitigant that is applied to the underlying exposures (either individually or to the entire pool), and hence benefits all of the securitisation exposures" (CRE 41.2); the SEC-IRBA formulation indicates that SEC-IRBA is calculated "as if the exposures were held directly by the bank [i.e. the securitisation noteholder]" and that "this calculation should reflect the effects of any credit risk mitigant that is applied on the underlying exposures (either individually or the entire pool), and hence benefits all of the securitisation exposures)" (CRE 44.3)).

assets and hence might expect to achieve risk weights below 100% even in relation to a 100% risk-weighted portfolio. It should also be noted that for NPE securitisations where the senior tranche principal is repaid first, this allows the deleveraging of the securitisation and would normally improve the credit rating of the senior tranche over time. A fixed 100% risk weight would remove this recognition of improved credit quality from the regulatory capital framework and reduce secondary market appetite for bank investors, as to which see further detail under 3 below.

The continuing exposure by the disposing firm to the senior tranche of its NPE securitisation is key to its execution, especially the need to place with investors the riskier low-rated or non-rated tranches. A 100% risk weight floor will therefore make such a transaction less cost-effective, and may prevent it altogether.

Further, the higher capital required will create particular difficulties for countries such as the UK, and/or securitisations secured by collateral of reasonable quality, where it is possible to achieve a relatively high rating of A/BBB for the senior tranche, resulting in a risk weight under SEC-ERBA of less than 100%, and sometimes also for those institutions which use the Advanced IRBA under the SEC-IRBA methodology. It is less likely to be an issue for institutions using SEC-SA but not impossible.

Instead, we would suggest that the floors should remain as they are today for securitisations of performing loans, given that the various approaches already aim to be risk-sensitive, prudent and take account of potential modelling difficulties. Furthermore, the risk weight for a senior tranche of an NPE securitisation position should be capped at the risk weight of the underlying exposures as is already allowed for performing securitisations.

We provide some relevant data below. We are conscious that this data is not UK data but it is the best publicly-available data we have been able to source from economies broadly comparable to the UK.

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

Popolare Bari NPLs 2016 S.r.l.	Baa1	90%
Prisma SPV S.r.l.	Baa1	90%
Spring SPV S.r.l.	Baa1	90%
FINO 1 Securitisation S.r.l.	A2	65%
European RLS 2019-NPL2 DAC	A2	65%
Siena NPL 2018	Baa1	90%
Grand Canal Securities 2-2017	A2	65%

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

We support the CP's proposal that no NPE-specific risk weight floor should apply under SEC-ERBA, and we believe the same should be true for SEC-IRBA and SEC-SA, both of which are also conservatively calibrated and are also more closely controlled by

regulators and policymakers. Indeed, logic would suggest that if anything the latter two approaches should be of less concern because of the closer regulatory scrutiny associated with them.

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

We understand that a QIS was undertaken prior to the development of the Basel Technical Amendment from which the 100% risk weight floor derives. We have not seen it. We therefore wonder how wide-ranging the data may be, and if it has been correctly interpreted.

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

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

Future evolution of NPEs across the UK and Europe, ex-Italy

Low sovereign ratings, and the slow enforcement aspects of Italian NPE securitisation, are not always found in other European countries, the US or Asia – and are not found in the UK. All global regions can expect to experience a wave of new NPEs in the coming months, especially with COVID-related forbearance measures coming to an end. It is therefore reasonable to expect more NPE securitisations in the A/A2 range (65% risk weight), or potentially even a little higher – and equivalent credit quality in unrated transactions.

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

Incentives will be created to change transaction structures

If the proposals in the CP are adopted, incentives will be created to change market structures which could include:

- encouraging a decline in credit quality of senior-most tranches – equivalent to the BB to low-BBB range for eligible pools or high BBB range (BBB to BBB+) for non-eligible pools; and

- excluding certain asset classes such as SME loans and residential mortgages which can make higher rated senior tranches (equivalent to high BBBs to single As) achievable.

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

3. ***A fixed risk weight of 100% for senior tranches of NPE securitisations with a minimum NRPPD of 50% should be replaced with a 100% risk weight ceiling for NPE securitisations with a minimum NRPPD of 20%.***

For the reasons stated in 2 above, a 100% fixed risk weight is even more inappropriate for senior tranches of a qualifying NPE securitisation. This is true both for originators (who will get some capital benefit from recognising the "loss" implicit in the NRPPD) and non-originator banks (who will not).[5] Where, for example, the NPEs securitised are predominantly residential or commercial mortgages, the risk weight of the senior tranche may be much lower owing to the appraised market value of the collateral securing the underlying loans. In such cases, the 100% fixed risk weight would prevent any bank exposed to the senior tranche (originator or otherwise) from getting any capital benefit to reflect what is clearly a reduction in risk of the position resulting from the credit enhancement (from the NRPPD and more junior tranches) of the senior tranche of the securitisation.. To enable a healthy NPE securitisation market to develop, a more risk-sensitive approach should be adopted.

We would recommend using 100% as a ceiling for senior tranches of qualifying NPE securitisations, rather than the fixed risk weight proposed in paragraph 2.2 of the CP. This is on the basis of the look-through approach already applied to performing securitisations, which should also apply to NPE securitisations. For defaulted assets in respect of which a write-down of at least 20% has already been taken, the risk weight of the underlying assets would be 100%. It therefore makes sense to say that, where a pool of defaulted assets has been sold into a securitisation with a NRPPD of at least 20% (rather than the 50% currently suggested as a minimum standard for "qualifying" NPE securitisations), the senior tranche should never be risk weighted at more than 100%. This amounts to an administrative adaptation of a principle already acknowledged in the CRR to be sound. Instead of requiring the 20% write-down to be taken at the asset level, it would be permitted to be taken in the form of a (minimum) 20% NRPPD at the transaction level. Of course, if the applicable capital calculation methodology permits a lower risk weight then that should be permitted because the purpose of the ceiling is to

[5] Note that in the latter case, this would impair the ability of regulators and government institutions to encourage banks to invest in NPL securitisations that may be deemed important to economic recovery because it would be highly unlikely that this investment would be economic to a bank investor.

avoid the securitisation capital methodology (which is designed to be conservative) being overly conservative and losing risk-sensitivity.

4. ***The proposed definition of an "NPE securitisation" should be amended to provide certainty about when a portfolio needs to be re-tested.***

The proposed definition of an NPE securitisation is one "backed by a pool of non-performing exposures the nominal value of which makes up not less than 90% of the entire pool's nominal value at the time of origination and at any later time where assets are added to or removed from the underlying pool due to replenishment, restructuring *or any other relevant reason*." (emphasis added).

This definition is broadly sensible and the members of the Joint Associations support it with a small modification. We would propose to delete the words "or any other relevant reason". This is because the definition dictates when firms are in the NPE securitisation capital calculation regime and therefore its details determine when firms have to re-test securitisations to which they are exposed to see whether that regime continues to apply. It is crucial that the points at which this reassessment needs to be undertaken should be clear. The words "or any other relevant reason" are too vague for this purpose.

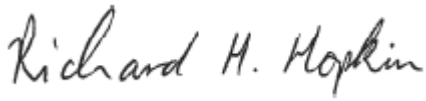
What is more, there are certain types of change in the underlying portfolio that should not trigger a reassessment, because they are part of the normal course of working out an NPE portfolio. For example, it is not unusual for the originator or other economic sponsor of a securitisation to decide (often on the advice of the special servicer) that a particular NPE is not likely to produce any further cash and should be bought back from the transaction and written off. It is not sensible to force a reassessment of whether the entire transaction is an NPE securitisation every time this happens. In our view, replenishment and restructuring are the two significant, originator/economic sponsor-led events that should trigger such a reassessment so the reference to "any other relevant reason" can simply be deleted. However, if the PRA would like to discuss other possible scenarios they believe should also be included, we would be pleased to do so. The key outcome we seek is to have a limited, reasonable and very clear list of scenarios that will trigger a re-testing of the 90% threshold.

5. ***Please confirm securitised NPEs may be excluded from the prudential backstop.***

On a separate point related to the subject of NPE securitisation, the Joint Associations would be grateful for confirmation from the PRA that NPEs securitised, either by traditional or synthetic structures, may be excluded from the NPE Backstop. Where NPEs are securitised, appropriate capital will be held against any retained securitisation positions and the prudential backstop is no longer necessary to ensure firms are retaining appropriate reserves to cover any losses.

In closing, we wish to emphasise that the engagement of the PRA with market participants on issues related to the implementation of the Basel Technical Amendment on capital treatment of securitisations of non-performing loans is appreciated. We are grateful for the opportunity to comment on the CP and we would be happy to answer any further questions that you may have.

Yours faithfully



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