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NON-PERFORMING LOANS: THE EVOLVING LANDSCAPE

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Sales of non performing loans ("**NPLs**") hit a four-year low in 2020, largely as a result of ongoing sales being put on hold as Europe entered lockdown and uncertainty regarding the performance of corporate and consumer debt. However, in recent months sales have risen significantly fuelled largely by government guarantee schemes. The most active jurisdictions have been Italy and Greece, with Italian sales constituting in aggregate approximately EUR 38.9bn, almost 60% of total sales in Europe.

In this article we examine some recent regulatory and market developments relevant to European acquisitions and financings of NPL portfolios. In particular (i) changes to Regulation (EU) 2017/2402 (the EU Securitisation Regulation or "**EUSR**") and to Regulation (EU) 2013/575 (the Capital Requirements Regulation or "**CRR**") which aim to remove some regulatory obstacles to the securitisation of NPLs; and (ii) the European directive on credit servicers and credit purchasers, including the standardised NPL transaction data reporting templates it will implement.

Amendments to the EUSR and CRR

The European Parliament adopted Regulation (EU) 2021/557 of the European Parliament and of the Council of 31 March 2021 amending the Securitisation Regulation (the "**EUSR CMRP**") and Regulation (EU) 2021/558 of the European Parliament and of the Council of 31 March 2021 amending the CRR (the "**CRR CMRP**") in each case as part of the "Capital Markets Recovery Package" – a response to the COVID 19 pandemic designed to aid recovery. The Securitisation Regulation had been criticised for failing to take into account the particular nature of NPL transactions and thereby hindering the securitisation of NPL portfolios. The amendments represent a welcome shift towards recognising the utility of securitisation as an ongoing funding tool to facilitate sales of NPLs, partly in anticipation of the predicted increase of NPL sales in Europe as a result of the impact of the pandemic.

The EUSR CMRP introduced the key definition of "NPE securitisation" for the first time. It is defined as follows:

> a securitisation backed by a pool of non-performing exposures[1] 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.

The introduction of the definition of "NPE securitisation" is significant as it forms the gateway to take advantage of the flexibility introduced by the amendments. It is worth noting that portfolios in the market often consist of not only non-performing loans but also the resulting real estate originally securing loans that have been foreclosed against (REOs) and that such REOs are no longer credit exposures of any kind. They therefore fall outside both the numerator and the denominator when determining the 90% for the purposes of the NPE securitisation definition.

The EUSR CMRP also made certain updates to the risk retention regime, which previously proved problematic in the context of NPL securitisations. Following these amendments, the EUSR now allows for the credit servicer to act as the risk retainer, provided that the servicer is able to demonstrate that it has the relevant expertise and policies, procedures and controls in place. It is interesting that qualifying criteria differ from the standard suggested in the EBA Opinion (the "**2019 EBA Opinion**") which formed the basis of these amendments[2]. The 2019 EBA Opinion had made the case that an independent servicer would be an appropriate retainer where its "interests in the successful workout of the assets are appropriately aligned with those of investors". It cited in particular the example where the servicer retained "the mezzanine and/or junior tranche and its fees are payable out of the collections from the assets as part of the securitisation's waterfall". This test is manifestly sensible, as it ensures that the alignment of interests is appropriate while leaving the assessment of expertise to those with an economic interest in the most profitable workout of the assets – the investors. It also aligns well with the pre-amendment requirement for the originator, original lender or sponsor to retain so that their interests would be aligned with those of investors – without any particular regulatory requirement for expertise. So while it seems like an appropriate and helpful amendment to permit the servicer to retain the risk retention on NPE securitisations, it does seem very odd to substitute an expertise requirement in place of the more obviously economically appropriate requirement that the servicers' interests should be economically aligned with those of the investors.

The EUSR CMRP also adjusted the risk retention rules to allow the size of the retention piece to be calculated based on the discounted value of the assets after deducting the non-refundable purchase price discount (or "**NRPPD**") applied when the securitisation vehicle acquired the assets, rather than by reference to the nominal values of the assets. This is a welcome recognition that holding 5% of the nominal value of a portfolio of loans whose value is considerably impaired was disproportionate and in many cases required a prohibitively high equity investment. By way of example, where the assets are sold into the securitisation with a 90% non-refundable purchase price discount – not unrealistic for an NPL securitisation – a requirement to retain of 5% of

1 Defined by reference to Article 47a(3) of the CRR.
2 Opinion on the regulatory treatment of non-performing exposure securitisations: https://www.eba.europa.eu/eba-publishes-opinion-regulatory-treatment-non-performing-exposure-securitisations

nominal value of the assets would be equivalent to 50% of the acquisition price of the portfolio, making the transaction uneconomical[3]. It is hoped that this change will encourage the growth of the NPL securitisation market by making these transactions more commercially attractive on both the buy and sell side.

Lastly, the EUSR CMRP amended the verification requirements under Article 9, which previously required that sell-side parties on NPL securitisations must verify the original lender's systems and credit-granting criteria. It also required that sell-side parties verify that the same criteria and systems were applied to exposures regardless of whether they were to be securitised. This was obviously inappropriate for most NPL transactions, where the original lending criteria and systems have generally long-since stopped being relevant to a current credit analysis. The amendments now mean originators must apply sound standards in the selection and pricing of the NPLs in the portfolio and will need to satisfy themselves that sufficient due diligence has been done to support this. The principles behind the amendment are logical – the original test was often impossible to verify in the context of NPL portfolios which are well-seasoned and often disconnected from the original lender through the passage of time or multiple sales. The changes to Article 9 are (imperfectly) mirrored in the amendments to Article 5[4] and the diligence requirements of institutional investors in an NPL securitisation.

CRR CMRP

On 26 November 2020, the Basel Committee on Banking Supervision (the "**BCBS**") published the technical amendment *Capital treatment of securitisations of non-performing loans*. The rule, which the Committee started developing before the onset of the pandemic, recognises the differences between securitisations of performing and non-performing assets and sets out new capital requirements for non-performing loan securitisations which are meant to be more risk sensitive while still being prudent. The general consensus of the European industry is that these changes, while helpful, remain overly conservative. The technical amendment established a flat 100% risk weight for "qualifying" senior tranches of NPL securitisations (under SEC-IRBA or SEC-SA) and established a floor of 100% risk weight for other tranches (under SEC-IRBA or SEC-SA). A securitisation will be "qualifying" if the assets are acquired by the securitisation with an NRPPD of at least 50%. It also banned the use of foundation IRB parameters for NPL securitisations when using SEC-IRBA, meaning banks either needed approval to use advanced IRB (own estimates of LGD and conversion factors) or would have to use SEC-SA or SEC-ERBA to calculate their capital.

The EU implemented the BCBS technical amendment, with some modifications, via the CRR CMRP. The amended CRR allows, for example, the risk-weighting of qualifying senior tranches of NPL securitisations to be risk weighted as low as 50% if that would be permitted under the look-through approach in Article 267 CRR. It also

3 NPL transactions have always been able to use vertical retention in such cases, since vertical retention is sized based on the liabilities of the transaction rather than its assets, but this meant transaction parties were artificially forced into vertical retention when commercial logic might normally have dictated the use of one of the other four methods.

4 Article 5(1)(f), introduced by the EUSR CMRP mirrors the new requirements for NPL verification in Article 9, but fails to disapply the general requirement to verify credit granting standards, systems and processes under Article 5(1)(a) or 5(1)(b), as the case may be. This potentially leaves institutional investors in an awkward position of having to verify credit-granting standards, systems and processes which originators on the same transaction need not look into or disclose against.

permits the deduction of the NRPPD from the expected losses for purposes of calculating the maximum capital to be held against the securitisation position under Article 268.

As a general matter, these amendments are helpful, but European industry views them as not well-adapted with the European NPL market. From an industry perspective it would have been preferable to implement the recommendations of the 2019 EBA Opinion more completely. It would also have been helpful to set the minimum NRPPD for a "qualifying" NPL securitisation lower (at, say, 20%) and make clearer the precise circumstances under which the 90% minimum for NPE assets in the portfolio needs to be retested over the life of the deal.

EU NPL Secondary Markets Directive

Credit servicers, sellers and purchasers

The new EU NPL Secondary Markets Directive (or "**NPL Directive**") regulates the purchase and servicing of NPLs originated by EU banks and imposes new obligations on banks selling NPLs (whether to bank or non-bank purchasers), purchasers of NPLs and servicers and includes new disclosure, reporting and authorisation requirements. The aim of the Directive is to standardise the rules for credit servicers and credit purchasers across the EU and standardise disclosure in order to facilitate the sale of NPL portfolios while ensuring that borrowers' rights are protected. A recent trend across Europe has been that NPL investors have been focused on the acquisition of credit servicers to enable them to control the business plan, maximize their deal collections and benefit from servicing fee revenue. The effect of the EU NPL Directive is anticipated to be to lower the cost of entry for potential loan purchasers by increasing the accessibility and reducing the costs of credit servicing, which should be welcomed. However, the remit of the Directive poses certain challenges as a result of the harmonisation and licensing requirements and a tension with local law consumer protection regulations which, while generally derived from EU law, maintain certain local peculiarities which cross border servicing teams will need to be mindful of.

While the directive came into force on 28 December 2021, member states are required to adopt and implement the rules by 29 December 2023 and bring the rules into effect by 30 December 2023. Notwithstanding this, the broad impact of the Directive on sales, purchases and servicing of NPLs will result in market participants needing to take steps to implement the rules well in advance to ensure that they are prepared to comply with the disclosure, reporting, borrower protection and authorisation obligations.

NPL data templates

The EBA initially developed NPL data templates in December 2017 to support NPL transactions and enhance the functioning of the secondary markets in the EU but it has been acknowledged that they were not widely used by market participants due to their "voluntary nature and complexity". The templates will no longer be voluntary under the NPL Directive, as it will require their use in connection with the sale of NPL portfolios.

In parallel with the end of the legislative discussions on the NPL Directive, therefore, the EBA published a discussion paper setting out *inter alia* a number of changes to the

existing templates intended to simplify their use for market participants including (i) reorganisation of the data categories and asset classes, (ii) reduction of data fields, (iii) classification of data fields as critical and non-critical, and (iv) the proportionality approach. The revised templates which were the subject of the discussion paper are not anticipated to be final but are expected to form the basis of an additional consultation before the publication of the final ITS under the NPL Directive.

Market participants recognise that compulsory data reporting in respect of NPLs is inevitable and, while the market is supportive of the ultimate objective of transparency, it is clear from the discussion paper that there is a great deal of variation in how different institutions record and monitor information and also the data available depending on the nature and history of the related underlying exposure and the requirements of the relevant jurisdiction. The data fields that are capable of being populated in respect of, or indeed that are relevant to, a highly-seasoned NPL portfolio that has been bought and sold multiple times will not be comparable to that of a relatively homogenous portfolio being sold by the original lender of the exposures. While the wider securitisation market has significant prior experience in adapting to higher and more prescriptive transparency requirements, the ease of compliance with further NPL reporting requirements will hinge on the lead-in time industry has to adapt and the categorisation of only a limited number of data fields as critical.

And it is not clear that there will be significant lead-in time. The NPL Directive allows some grandfathering in that the diclosure templates apply mandatorily to credits originated on or after 1 July 2018 that became non-performing after 28 December 2021. That said, if a credit becomes non-performing before the final templates come into force (expected to be September 2022), then the data templates need only be completed with the information available. Accordingly we expect that the requirements will pose significant challenges given what we know of the NPL market, where there is currently little homogeneity in the form of data collected on exposures and where portfolios are bought, merged with other portfolios and onsold between both bank and non-bank market participants.

NPL transactions – recent market developments

During 2020 and 2021, there was an increasing use of securitisation techniques to finance the acquisition of NPL portfolios. Prior to 2018, the vast majority of NPL transactions were structured as private acquisitions financed by a senior loan which was then typically syndicated to a small number of investors who remained in the transaction to maturity. The exceptions were some of the large UK and Irish disposals of performing and near-prime residential mortgage portfolios which were securitised at the point of acquisition or shortly thereafter. While such private senior loan transactions are still commonplace, the market is seeing more and more transactions, particularly in Greece, Spain and Portugal, that are being structured as public or private securitisations, while in Italy NPL transactions have been from the outset mostly structured as securitisations.

In the case of Greece, NPL securitisations have been structured mainly as private transactions, with Irish Section 110 Companies being the preferred buyer/issuer for tax reasons. Sponsors and originators can structure the sale and transfer of non-performing loans and credit receivables in Greece under one of two possible legal frameworks, (i) the long standing Greek securitisation law (Law 3156/2003) (the "**Greek Securitisation Law**") or (ii) the "new" Law 4354/2015 (the so called "**Greek NPL Law**"). The choice of the applicable legal framework depends largely on the objectives of the banks and the type of loans that make up the portfolio but the former remains the preferred tool of international investors for disposal of NPLs by banks, especially because of the requirement of the Greek NPL Law for the transaction to be subject to Greek law.

More recently, and since launching the Hercules Asset Protection Scheme (HAPS)[5], NPL securitisations in Greece have been required to adapt to the features set out in the HAPS Law. Although these transactions remained generally structured as private transactions, sponsors and originators have been required to take into account rating, listing, tranching and seniority requirements.

In Italy, NPL transactions are typically structured as securitisations, either public or private. This is done for a variety of legal, regulatory and tax reasons, among others. NPL portfolios are acquired by a special purpose vehicle established under the Italian securitisation law no. 130/1999. As the SPV is not a regulated entity (although it is registered in a special register with the Bank of Italy), the securitisation law requires that a bank or a regulated financial intermediary is appointed to service the portfolio. The acquired portfolios benefit from statutory segregation and the particular acquisition regime applicable to Italian securitisation vehicles allows them to benefit from an exemption from any security transfer taxes. Quite recent changes in the securitisation law extended the statutory segregation to the relevant REOCOs that operate within the context of – and for the benefit of – the securitisation.

In the case of Spain and Portugal, NPL transactions are structured using the relevant securitisation laws. In Spain structures use a securitisation fund vehicle (known as an "FT") and in Portugal they use a credit securitisation company (known as an "STC"), both of which benefit from the principle of statutory segregation pursuant to the national securitisation laws under which they are established. As many of these portfolios comprise a significant number of REO assets rather than loans, the advantage of employing such a securitisation structure and relying on the statutory segregation is that it avoids the need to take security over the REO assets and the payment of stamp duty on the creation of such security. In addition, in the Spanish market, a number of transactions have been structured using a joint venture structure, where the seller contributes the NPL and REO assets to a newly incorporated subsidiary, with typically 80% of the share capital of the new subsidiary being sold to the third-party buyer, again avoiding the need to pay stamp duty as opposed to a sale and transfer of the NPLs and REOs as an asset transfer.

5 The HAPS programme is similar to the Italian GACS whereby the most senior tranche of notes benefits from a government guarantee.

Conclusion

The legislative and regulatory changes discussed in this article have a set of common intentions, including reducing high-levels of NPLs building up on the balance sheets of banks, and facilitating the use and growth of a secondary market for sales and purchases of NPL portfolios. It should be noted that as at 31 December 2020, the UK and EU positions were largely identical, meaning the EU changes (the CMRP and the NPL Directive) represent a divergence between the two regimes. It remains to be seen whether the direction of travel for the UK will match that of the EU.

Notwithstanding the good intentions, it is far from clear that the changes made by the EU actually achieve their objectives. The market expectation is for NPL disposal volumes and associated financing transactions to continue to rise, driven largely by demand from banks to reduce their balance sheet NPL exposure coupled with the continued appetite of experienced NPL investors to invest in the asset class. At the same time, the pandemic has increased the need for lending institutions to manage and deal with their non-performing exposures and it is anticipated that the volumes of NPLs on balance sheets will increase following the roll-off from government-mandated payment holidays and other borrower forbearance schemes.

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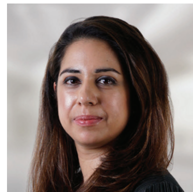

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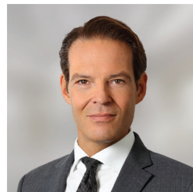

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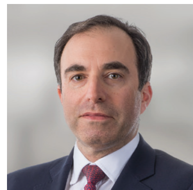

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