German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on capital treatment of securitisations of non-performing loans (BCBS d504)

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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General comments

While non-performing loans ("NPL") ratios' have been falling significantly over the past year, Covid-19 is expected to put pressure on this path. One of the ECB estimates on loans losses shows that these could increase to 3% of total loans to NFCs, i.e. EUR 160bn. Together with existing NPL stock (EUR 543bn as of Sept 19), total is expected to rise substantially in excess of EUR 0.6tn.
Against this background it is essential measures are taken to support the continuous downward trend in Europe and globally. Securitisation will be one of the key instruments to off load NPL portfolio's, thereby increasing the stability of banks.

The Basel proposal is not risk sensitive
In our view, the Basel proposal does not provide the support needed to tackle a potential future increase in NPL ratios. The Basel proposal is a non-transversal approach that breaks any linkage between the risk of a portfolio and that exhibited by a senior tranche.

- It would take away the internal model for determining the risk weight, a key principle behind the redesign of the securitisation framework including the re-prioritisation of the hierarchy of approaches.
- It would introduce a purchase price discount significantly higher (i.e. 50% vs 20%) than that which would apply for on-balance sheet exposures that both would take away a key "risk-link" represented by "as if it had not been securitised" and would incentivise a bias by assuming securitised NPLs are always worse compared to those on balance sheet.
- It would take away the credibility, expertise and risk sensitivity brought in through external rating agencies that could lead to less data collection and analysis on NPLs which could stunt the development of the NPL securitisation market.

The Basel proposal will lead to reduced sales prices of NPL for institutions, hindering them to reduce their NPL
Strong investor demand and financing appetite have supported the deleveraging of the European banking sector through the sale of loan portfolios, mostly NPLs.
This has been partially aided by government-backed schemes (e.g. GACS in Italy, Hercules in Greece), national Asset Management companies (e.g. Sareb in Spain, NAMA in Ireland) or certain developments in the legal/regulatory space. External servicers have become more effective in working out NPL portfolios and have often been financially backed by PE firms and other regular NPL portfolio buyers.
Private Equity firms are among the top buyers of NPL portfolios who typically seek leverage through privately arranged financing from institutions (i.e. mainly banks). Financing is usually structured as recourse only to the NPL portfolio – senior securitisation position.
The Basel proposal would result in a minimum risk weight of 100% that is likely to lead to higher financing charges and consequently materially reduced sale prices for institutions seeking to sell NPL portfolios. To achieve a 10% return, senior financing margin against NPL portfolios would have at a minimum to more than double (to 6.5% in the event of Basel proposal being implemented). Lower sale prices will lead to: (i) higher provisions / losses for the selling institution; or (ii) no sale leading to a failure in reducing NPL level for the institution.

The discussed revision should be postponed until there is enough data on the effect of COVID-19 on NPL
It was our expectation that Basel would take forward the work of re-calibrating the SEC-IRBA and SEC-SA formulae through the consideration of the p-factor and risk parameter inputs being on a net basis.

This has not been the case and rather the Basel proposals risks creating higher risk weights than currently apply. It is therefore not supporting an effective and efficient reduction of NPL levels of banks. Further, while we have not seen the QIS, from our knowledge of today's European market we struggle to see evidence that supports the Basel proposal. The incidence of NPLs will likely increase over the next few months and years; this should provide the BCBS with a wider, global data set to review, at a global level, the appropriate regulatory capital treatment of securitised NPL portfolios.
For these reasons, we respectfully submit that in our opinion it would be premature for the BCBS to implement a revision to a Basel standard that may well need to change in the near future. Only if the BCBS takes on board all changes listed below in the detailed comments, would this come close to being beneficial for future European NPL reductions.

Detailed comments

Paragraph 45.1
"A non-performing loan securitisation (NPL securitisation) means a securitisation where the underlying pool's variable W, as defined in CRE41.6, is equal to or higher than 90% at the origination cut-off date and at any subsequent date on which assets are added to or removed from the underlying pool due to replenishment, restructuring or any other relevant reason."

We recommend that the definition of W and the underlying pool of exposures of an NPL securitisation should also include any enforced collateral that secured a non-performing loan including foreclosed real estate held / owned (directly, beneficially or otherwise) by the securitisation prior to its sale.

Paragraph 45.2
"National supervisors may provide for a stricter definition of NPL securitisations than that laid out in CRE 45.1. For these purposes, national supervisors may:
(1) raise the minimum level of W to a level higher than 90%; or
(2) require that the non-delinquent exposures in the underlying pool comply with a set of minimum criteria or preclude certain types of non-delinquent exposures from forming part of the underlying pools of NPL securitisations.
Without prejudice to the foregoing, national supervisors should scrutinise NPL securitisations to prevent any instances of regulatory arbitrage. In particular, national supervisors should preclude transactions executed with the main purpose of reducing the capital charge on the non-delinquent exposures in the underlying relative to the 100% risk weight on the senior exposure to the NPL securitisation referred to in CRE45.3."

The Committee allows the NCAs to implement stricter criteria. However, to ensure a level playing field and consistency in application no such discretion should be permitted.

Paragraph 45.3
"A bank should assign a fixed 100% risk weight to the senior tranche of NPL securitisations instead of applying the hierarchy of approaches referred to in CRE40.41 to CRE40.47 and the look-through approach referred to in CRE40.50 when the following three conditions are met:
(1) the NPL securitisation is a traditional securitisation;
(2) the underlying pool of exposures was securitised at a discounted price on the outstanding amount of the pool of exposures and the discount is not refundable to the originator or original lender (the non-refundable purchase price discount or NRPPD); and

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(3) the NRPPD referred to in (2) was equal to or higher than 50% of the outstanding amount of the pool of exposures as of the origination cut-off date;"

We recommend the following changes:
In relation to the hierarchy of approaches:

- For SEC-IRBA remove the fixed 100% risk weight and the NRPPD of at least 50% threshold.
- For SEC-SA reduce the threshold for NRPPD from 50% to 20%
- Fixed 100% risk weight disapplied for SEC-ERBA

In relation to the look-through approach:
Adopt the EBA's Opinion summarized as:

- SEC-IRBA: Full net basis calculation; and
- SEC-SA: 100% risk weight if NRPPD is at least 20%

NRPPD of 20% would align to the application of 100% risk weight for on-balance sheet NPL under Article 127(1)(b) and therefore maintaining the key principle within Article 267(1) "as if the underlying exposures had not been securitised".

Paragraph 45.5
"In all other cases, banks must follow the hierarchy of approaches referred to in CRE40.41 to CRE40.47 or the look-through approach referred to in CRE40.50. However, where an exposure to an NPL securitisation may be assigned a risk weight of less than 100% in accordance with these approaches, a risk weight floor of 100% should instead be used for that exposure."

We recommend removing the 100% risk weight floor.

Paragraph 45.6
"An originator or sponsor bank may apply the capital requirement cap specified in paragraph CRE40.54 to the aggregated capital requirement for its exposures to the same NPL securitisation. The same applies to an investor bank, provided that it is using the SEC-IRBA for an exposure to the NPL securitisation."

Additionally, "look-through" approach to senior securitisation exposures specified in paragraph CRE40.50 may be applied.

We recommend that under both approaches, the expected losses should be calculated net of NRPPD and of any additional specific credit risk adjustments. More specifically, a "full net basis calculation" should be the preferred approach for the purposes of applying the caps under SEC-IRBA to NPL securitisations. A full net basis calculation means that both the "expected losses" and "exposure value" referred to in CRE 40.50 and "expected losses" referred to in CRE 40.52 should be net by the amount of the relevant NPL's NRPPD and, in the case of the originator, any additional specific credit risk adjustments. The same applies to an investor bank, provided that it is using the SEC-IRBA for an exposure to the NPL securitisation.

<u>Rationale:</u>
The caps for securitisations within CRE 40.54 and CRE 40.50 are 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. Therefore, application of the "full net basis calculation" should be the preferred approach for applying the caps under the SEC-IRBA to NPL securitisations.

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.