

## Why Reperforming Loan Securitization In UK And EU May Rise

By **Richard Hanson, Oindrila Bhowmik and Gulmin Cosar** (July 4, 2024, 5:57 PM BST)

The U.K. Financial Conduct Authority and Prudential Regulation Authority published their new U.K. securitization rules in April, which also include provisions relating to nonperforming loan, or NPL, securitization.[1]

These diverge in part from the equivalent provisions in the European Union's Securitization Regulation.[2] The positive effects of legislative packages such as these that have an impact on NPL securitization continue to build, and as a result it can be expected that NPLs that have become reperforming loans may feature more prominently in the European and U.K. securitization markets going forward.

An elevated level of NPLs on European and U.K. banks' balance sheets has driven a slate of legislation and regulation in recent years, including directives aimed at developing and enhancing a secondary market for NPLs and regulation on the development of NPL securitization.

The European Council's action plan to tackle nonperforming loans in Europe, adopted on July 11, 2017, was aimed at developing a secondary market for NPLs in Europe, as one of the building blocks of an efficient so-called European capital markets union.[3]

European and U.K. banks now have various options for addressing NPLs, including securitization, e.g., via certain government guarantee or asset protection schemes, outright sales and asset management companies.

Against this backdrop, regulation in Europe has developed to remove constraints on the development of NPL securitization, including amendments to the EU Securitization Regulation and the Capital Requirements Regulation,[4] as part of the 2021 Capital Markets Recovery Package.

In the U.K., the securitization rules will for the most part bring the NPL securitization regime in line with that of the EU.

Aside from securitization, the recently implemented EU directive on credit servicers and credit purchasers, known as the NPL directive[5] — is designed to enhance the secondary market for NPLs generally. It includes increased regulation of not just selling banks but also the purchasers of NPLs and servicers, with enhanced loan-level data requirements designed to improve transparency in the



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secondary markets.

This article will recap such legislation and relevant upcoming policy and regulatory changes, how successful NPL securitization has been for banks in Europe and the U.K., and looking ahead, how reperforming loan securitization may feature more prominently in the market.

### **The Market Now**

Securitization in Europe via government guarantee schemes, such as the Garanzia sulla Cartolarizzazione delle Sofferenze in Italy[6] and the Hellenic asset protection scheme in Greece,[7] has been instrumental in markets with high levels of NPLs. It can offer a lower average cost of funding, protection for senior investors, and legal certainty without contravening European state aid rules.

In Italy and Greece, both of which had elevated levels of NPLs, state-guaranteed securitization has been instrumental. The local NPL markets at the time were not mature enough to absorb such large numbers of NPLs through traditional NPL securitization. While these securitizations entailed higher transaction costs, they also minimized potential losses for senior noteholders compared to traditional securitizations and outright sales.

Public NPL securitizations outside of government asset protection programs are dependent on securitization market conditions, which have been volatile over the last few years. As a result, largely due to their simplicity and lower costs, outright sales have been the first port of call for European and U.K. banks to dispose of NPLs.

NPL securitization should generally pursue the same aims as an outright sale, which is to deconsolidate nonperforming assets from the balance sheet with some added benefits, i.e., providing access to a broader spectrum of investors who cannot hold NPLs directly, and creating tranching securities with different risk profiles.

However, these benefits come with some complexity, including setting up the documentation and the systems to ensure that a transaction complies with applicable regulatory obligations.

A further problem specific to NPLs is that fulfilling the business plan is more uncertain than in the case of performing loans or reperforming loans.

Since the Garanzia sulla Cartolarizzazione delle Sofferenze scheme expired in June 2022, a continued reduction in large Italian NPL securitizations is envisaged.[8] Conversely, the Hellenic asset protection scheme was renewed in December 2023, with an expiration date of December 2024. As such, both systemic and other nonsystemic Greek banks may take advantage of this renewal and securitize some or all of their remaining NPL portfolios before the guarantee expires.[9]

### **Recent Legislative and Regulatory Changes**

The package of measures aimed at reducing the NPL predicament in Europe and the U.K. has already been successful, evidenced by NPL ratios having decreased across the board.

These measures include amendments to the EU Securitization Regulation, which, among other things:

- Define a new category of NPL securitizations;

- Allow the servicer to act as risk retainer, since its interests are more aligned to those of the investors in terms of the recovery process;
- Provide for the size of the risk retention piece to be calculated by reference to the discounted value of the assets and not the nominal value to reflect the fact that it is the discounted value that represents the actual risk of loss to investors; and
- Replace the requirements with respect to verification of credit-granting standards, with a duty to apply sound standards in the selection and pricing of the exposures.[10]

The U.K. securitization rules, insofar as they relate to NPLs, will be in line with the EU Securitization Regulation's equivalent provisions, except in respect of the ability for the servicer to act as risk retainer.

This may reflect the fact that the use of the servicer as the eligible risk retainer has not been widely adopted in the EU market as a risk retention option, but market participants have flagged this omission to the Financial Conduct Authority for future consideration.

In addition, amendments to the Capital Requirements Regulation under the capital markets recovery package have, among other things, introduced specific and more risk-sensitive capital treatment for positions in European NPL securitizations, addressing disproportionate capital requirements under the securitization internal ratings-based and securitization standardized capital approaches when applied to NPL securitizations.

As part of these amendments, NPL securitizations benefit from a 100% risk weight for senior tranches of traditional securitization, and a floor of 100% to the risk weight of other tranches of both traditional and on-balance sheet synthetic NPL securitizations that are subject to the general framework for calculation of risk weights.

In addition, the amendments to the Capital Requirements Regulation set out that the expected losses and exposure values in respect of the NPL portfolio shall be calculated net of the nonrefundable purchase price discount.[11] No equivalent changes were made to the onshored version of the regulation in the U.K. following the application of the capital markets recovery package.[12]

In terms of regulatory developments outside of securitization, the NPL directive imposes obligations on European banks selling NPLs, nonbank purchasers of European NPLs, and NPL servicers.

While the directive carves out securitizations from its scope, the adoption and entry into force of the Implementing Technical Standards on NPL transaction data templates is expected to foster consistency and transparency in terms of loan-data disclosure, similarly to how the EU securitization regulation has developed a more coherent and standardized approach to disclosure in the context of NPL securitization.[13]

Notification to the European Securities and Markets Authority in Europe, and the Financial Conduct Authority and the Prudential Regulation Authority in the U.K., is especially important for NPL securitizations.

Such notification provides transparency about the securitized NPLs and the related risks, and the same applies to outright sales, although we note that there is no legislation applicable in the U.K. that is equivalent to the directive as yet.

## **Regulatory or Policy Changes Under Consideration**

There are some open issues to be resolved under the directive. In particular, the European Commission is taking infringement action against member states that failed to transpose it into national law by the set deadline of December 2023.

In addition, the adopted Implementing Technical Standards under the directive do not address some of the issues relating to the other obligations of selling banks, purchasers or servicers under the directive.

This includes the application of the obligations of purchasers to non-EU banks that buy NPLs, the application of the obligations of purchasers and servicers in relation to loans acquired by purchasers before Dec. 30, 2023, and the treatment of facility agents and security trustees under the directive.

We expect these open issues will be addressed in due course by guidance from the commission, the European Banking Authority or national regulators, common industry approaches or national implementing rules.

The U.K. has not adopted any equivalent legislation to the directive as yet.

## ***Other Relevant Potential Reforms In Europe***

The bank recovery and resolution aspect of the NPL action plan, still at the legislative proposal stage, is a framework for authorities to manage bank failures effectively and organize an orderly market exit for failing European banks.[14] However, this needs to be viewed in context — European banks are now very well capitalized, which somewhat reduces systemic risk in the banking sector.

There are major inconsistencies between national insolvency regimes that pose issues with regard to avoiding a loan becoming an NPL, thus potentially hindering the swift resolution of NPLs by banks and other entities.

The Association for Financial Markets in Europe has voiced its support for the development of European legislation harmonizing minimum standards of insolvency proceedings to facilitate more predictable and efficient corporate restructurings.[15]

A challenge to the regulatory requirements around regulatory disclosure has been the quality of available data. The European Securities and Markets Authority has defined data validation rules to establish a minimum level of data accuracy, correctness and consistency, but in practice these only apply to public securitizations.

As such, the centralization of NPL transaction data is at the forefront of regulators' minds to further improve market transparency and attract new investors. The NPL action plan has also proposed the creation of an EU data hub that would be a repository to collect all transaction data for European NPL transactions. This would improve efficiency in the markets, eliminating the bid or ask spread issue posed by information asymmetries.

## **The Future of Reperforming Loans**

Given the success of European and U.K. banks in reducing their NPL ratios and the growth of the secondary NPL market — aided by the legislative and regulatory changes highlighted above — we may

see more reperforming loan securitizations playing a part in the European securitization market going forward, and perhaps the volume of reperforming loan securitization issuance overtaking that of NPL securitization.

This is even more likely given advances in servicing technology, the increased regulation of servicers, and a more stable interest rate environment.

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[1] The FCA rules are set out annexes to the FCA's Policy Statement PS24/4. The PRA rules are set out in appendices to the PRA's Policy Statement PS7/24. The Securitisation Regulations 2024 can be found at <https://www.legislation.gov.uk/uksi/2024/102/contents/made> and the draft Securitisation (Amendment) Regulations 2024 can be found at <https://www.legislation.gov.uk/ukdsi/2024/9780348260670/introduction>.

[2] Regulation (EU) 2017/2402 : <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2402>.

[3] <https://www.consilium.europa.eu/en/press/press-releases/2017/07/11/banking-action-plan-non-performing-loans/pdf>.

[4] Regulation (EU) 2017/2402: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017R2402>; Regulation (EU) No. 575/2013: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575>.

[5] Directive (EU) 2021/2167: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021L2167>.

[6] [https://www.mef.gov.it/en/focus/sistema\\_bancario/Guarantee-on-Securitisation-of-Non-Performing-Loans-GACS/](https://www.mef.gov.it/en/focus/sistema_bancario/Guarantee-on-Securitisation-of-Non-Performing-Loans-GACS/).

[7] <https://hfsf.gr/en/banks-asset-quality/>.

[8] [https://italy.representation.ec.europa.eu/notizie-ed-eventi/notizie/aiuti-di-stato-la-commissione-approva-la-proroga-dello-schema-di-garanzia\\_it](https://italy.representation.ec.europa.eu/notizie-ed-eventi/notizie/aiuti-di-stato-la-commissione-approva-la-proroga-dello-schema-di-garanzia_it).

[9] [https://ec.europa.eu/commission/presscorner/detail/en/IP\\_23\\_5805](https://ec.europa.eu/commission/presscorner/detail/en/IP_23_5805).

[10] <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0557>.

[11] Article 269(a)(5) of the Capital Requirements Regulation. Note that the UK Securitisation Rules allow for the discounted value of the NPLs to be used instead of nominal value in calculating the 5% material net economic interest for the purposes of risk retention although no equivalent provision was

included in respect of the Capital Requirements Regulation.

[12] [https://ec.europa.eu/commission/presscorner/detail/en/inf\\_24\\_286](https://ec.europa.eu/commission/presscorner/detail/en/inf_24_286).

[13] <https://www.eba.europa.eu/legacy/regulation-and-policy/regulatory-activities/credit-risk/implementing-technical-standards-npl>.

[14] [https://finance.ec.europa.eu/publications/action-plan-tackling-non-performing-loans-npls-aftermath-covid-19-pandemic\\_en](https://finance.ec.europa.eu/publications/action-plan-tackling-non-performing-loans-npls-aftermath-covid-19-pandemic_en).

[15] <https://www.afme.eu/news/press-releases/details/afme-welcomes-the-publication-of-the-eu-implementation-of-final-basel-iii-standards-and-stresses-the-need-for-jurisdictional-coordination>.