Capital Markets Recovery Package (CMRP) - Quick fixes or long-term solution?

CMRP has introduced new EU rules for NPL securitisations and a framework for "STS" synthetic securitisations

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On 1 January 2019 EU Regulation 2402/2017 (Securitisation Regulation) started to apply, giving rise to one of the most ambitious capital markets projects of the EU: the creation of an homogeneous regulatory framework applicable to all European securitisations. The goal of the project was high: revamping and strengthening the EU securitisation market and, in particular, revitalising "public deal" activity.

Prior to the arrival of the Covid-19 crisis, the Securitisation Regulation was brilliantly accomplishing its mission, as in 2019 it led to a substantial rise of new public securitisations. The main appeal for the investors had been a magic word: "STS". In fact, all these public securitisations complied with the new Securitisation Regulation's criteria allowing them to be classified as simple, transparent and standardised (**STS**) and, as such, benefitting from a more favorable prudential treatment, in light of their lower risk profile.

Covid-19 triggered an inevitable slow-down in securitisation issuance and, as a result, in 2020 there were very few STS securitisations placed in the market through public placements (as most of them were retained by the originators or used as collateral in the context of open market transactions with the European Central Bank).

However, the EU securitisation market will now receive a new boost from the so called "Capital Markets Recovery Package" (**CMRP**), being a new set of pandemic legislative measures approved by the European Parliament on 25 March 2021.

The CMRP has introduced certain changes to the Prospectus Regulation, MiFID II and the EU securitisation framework which will allow the capital markets to better support the recovery of the economy from the crisis caused by COVID-19. The changes to the EU securitisation framework have been made both at Securitisation Regulation and CRR[1] level, with two separate legislative acts which may be found here and here.

The above two legislative acts are not yet in force as they will need to be approved by the Member States and then published in the Official Journal. Thus, it is likely that the CMRP will come into force between April and May 2021.
This note will focus on the amendments of the CMRP dealing with the securitisation which involve mainly the following topics:

- Non-performing loans (**NPL**), with the removal all certain existing regulatory obstacles to their securitisation; and
- Synthetic securitisations, with the introduction of a specific STS framework for these type of deals ("on-balance sheet securitisations").

New EU rules facilitating NPL securitisations

Introduction

The COVID-19 crisis will inevitably increase the number of NPL and the need for institutions to effective deals with these loans. EU authorities are well aware that one of the most efficient instrument to manage NPL is to trade them on the capital markets through securitisation techniques.

That said, the first two years of application of the Securitisation Regulation have clearly shown that certain elements of the risk retention and due diligence requirements established thereunder do not adequately take into account the specific features of NPL deals. This had made the securitisation of NPL difficult and, in some cases, prevent the securitisation of these type of assets.

To facilitate the securitisation of NPL, the CMRP has introduced in the Securitisation Regulation three new risk retention and due diligence principles applicable exclusively to NPL which will remove the existing regulatory obstacles to securitisation.

Risk retention by Servicer (not Originator/Sponsor)

The Securitisation Regulation's risk retention obligations (Art. 6) require the originator, the original lender or the sponsor to retain a material net economic interest of not less than 5% in the securitisation. The retainer is usually the original lender or acquirer of the exposures to be securitised.

This is not the case in NPL securitisations, where identifying a suitable risk retention holder proves to be frequently problematic. Often the seller of the NPL has not originated them and/or does not want to maintain any involvement and risk in the securitisation after having removing the NPL from its balance sheet. The CMRP's amendment has resolved this issue by allowing the risk retention holder to be the servicer. In fact, in the context of NPL securitisations, which depend on work-out, realisation and reperformance of the underlying exposures, the servicer usually has a more substantial interest than the original lender in the recovery process. Accordingly, the interests of the servicer are better aligned with those of the investors in this context. To qualify as risk retention holder the servicer will need to satisfy the two following requirements:

- being able to demonstrate that it has expertise in servicing exposures (of a similar nature to those securitised); and
- having well-documented and adequate policies, procedures and risk-management controls relating to the servicing of exposures.

Risk retention to be calculated on NPL discounted value (not nominal value)

The Securitisation Regulation requires the material net economic interest to be retained (both of the notes or the receivables) to be calculated on a nominal value / par value basis (Art. 6). In the case of NPL securitisation, this overstates the risk retention requirement as it does not reflect the price discount at which NPL are transferred representing the actual risk of loss for investors. The new rules introduced by the CMRP have addressed this issue by establishing that in NPL securitisations the risk retention is to be determined on the basis of the discounted value, according to the following principles:

- the risk retention shall not be less than 5% of the net value of the NPL (plus, if applicable, the nominal value of any performing securitised exposures);
- the net value of the NPL shall be determined by deducting the discounted purchase price from the exposure's nominal value or, where applicable, the outstanding value at the time of origination; and
- for the purpose of determining the net value of the NPL, the purchase price discount may include the difference between (a) the nominal amount of the ABS underwritten by the originator (for subsequent sale) and (b) the price at which ABS are sold to unrelated third parties.

Sound standards in selection and pricing of exposures (and not credit-granting)

Finally, the CMRP amendment has also introduced in NPL securitisations changes to the credit granting requirements (Art 9). In NPL deals credit-granting standards are only of little relevance and also difficult to verify as the securitised assets have often been originated long before the transaction and/or by an entity other than the seller.

To resolve the above issue the CMRP amendment has replaced these requirements with the duty to apply sound standards in the selection and pricing of the exposures and the obligation on the investors to verify this in the due diligence, thereby facilitating the verification of the quality and performance of the assets and a sensible and well-informed investment decision.

New STS framework for synthetic securitisations

The STS framework for synthetic securitisations contained in the CMRP is a "promise made by the EU legislator which has been maintained". The original (and existing) STS framework excluded synthetic securitisations, on the basis that they generally involve the transfer of the credit risk through derivatives or guarantees. This creates additional counterparty credit risk and an additional level of complexity. However, the Securitisation Regulation also explicitly recognised the importance of synthetic securitisations for the real economy, and, in particular, small and medium enterprises (**SME**). As a result the Securitisation Regulation (Art. 45) already established the steps for the creation of an STS framework for synthetic securitisation. The CMRP has been preceded by a feasibility report prepared by the EBA (European Banking Association), in cooperation with ESMA (European Securities and Markets Authority) and EIOPA (European Insurance and Occupational Pensions Authority).

The following paragraphs summarise they key features of the STS framework for synthetic securitisation contained in the CMRP.

- <u>STS for on-balance sheet synthetic securitisations only</u>: first of all, the STS label will be available only for on-balance sheet deals, being those most used in the context of SME

financing. Conversely arbitrage synthetic securitisations have been excluded from STS as they are mostly "investors" driven.[2]

- Favorable prudential treatment: STS synthetic securitisations will benefit from a differentiated favourable prudential treatment through amendment to Article 270 of the CRR.
- Common STS Requirements (with traditional securitisations): many STS requirements are common to those applicable to traditional securitisations, with some of them having been adapted to take into account specific elements of synthetic deals. The main of these common requirements are the following:
    - Simplicity: (i) eligibility criteria (to be predetermined/clear/documented); (ii) no active discretionary portfolio management; (iii) homogeneous exposures (only one asset type); (iv) contractually binding/enforceable exposures; (v) exposures having defined periodic payments; (v) exposures which are not themselves securitisation positions; (vi) disclosure of underwriting standards; (vii) originator expertise; (viii) no exposures in default; (ix) no credit-impaired debtor/guarantor; (x) debtors having made at least one payment,
    - Standardisation: (i) risk retention compliance; (ii) interest rate/currency risks to be mitigated; (iii) non-sequential priority of payments reverting to sequential upon performance triggers; (iv) appropriate early amortisation events/revolving period triggers; (v) clear duties of the transaction parties and replacement provisions; (vi) servicer's expertise.
    - Transparency: the requirements are nearly identical to those established for traditional securitisations.
- Specific STS Requirements: there will be a set of new requirements specific to synthetic securitisation aimed at ensuring, among other things, that the credit protection agreement (**CPA**) adequately protects the originator and the investor by addressing counterparty credit risk.
- CRM/SRT eligibility: the CPA will have to meet the credit risk mitigation requirements established by the CRR (Art. 249) for synthetic securitisations seeking SRT (significant risk transfer).
- Reference register: the reference obligations will have to be clearly identified through a reference register, and kept up to date.
- Credit events CRR compliant: these will have to comply with the CRR requirements for guarantees or credit derivatives (depending on the type of credit protection).
- Sound/transparent settlement process: to protect the originator's right (as protection buyer) to receive timely payments on losses, the deal will have to contemplate a sound and transparent settlement process for the determination of such losses in the reference portfolio.
- Third-party verification agent: this should be appointed upon occurrence of a credit event with the task of reviewing the correctness and accuracy of certain aspects of the credit protection.
- Credit protection premiums: they will have to be linked only to the outstanding size/credit risk of the protected tranche. Non-contingent/up-front or complex premiums will not be permitted as they can jeopardise the effective credit risk transfer.
- Early termination by originator: this will be possible only in certain limited circumstances (e.g. (i) regulatory events; (ii) investor's insolvency or failure to pay; (iii) clean-up call (to be CRR compliant)).
- Credit protection arrangements: only high quality CPA will be eligible. Hence, for an unfunded CPA the protection providers will have to (i) meet the CRR eligibility requirements and (ii) have a 0% risk-weight according to the CRR (Part Three, Title II, Chapter 2). In case of a funded CPA, the originator, as protection buyer, and the investors, as protection sellers,

will need to have recourse to high quality collateral (i.e. with a 0% risk weight according to the CRR), subject to appropriate deposit/custody arrangements. Finally, any cash collateral will have to be held with third-party credit institution or on deposit with the protection buyer, subject in both cases to a minimum credit quality standing.
- Synthetic excess spread: this will need to be fully disclosed so as to mitigate supervisory concerns and standardise it. Moreover a new capital charge will be applicable to synthetic excess spread in all synthetic securitisations (also non STS), so as to avoid its use for regulatory arbitrage purposes (new Art. 248 and 256 of the CRR).

Conclusions

The new rules introduced by the CMPR will lead to a further improvement of the regulatory framework for the European capital markets. Particularly, securitisation has traditionally proven to be one of them most efficient instrument to manage and resolve the issues deriving from the NPL. The CMRP will facilitate substantially the use of such instrument by making it more consistent with the actual features of the NPL deals and market. Further, the introduction of a specific STS label for on-balance sheet synthetic securitisations will provide the real economy and, in particular, SME, with a new important tool to manage and transfer credit risks through the capital markets.

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Notes

1. Regulation EU 575/2013.

2. The EBA Report defines arbitrage synthetic securitisations as "*transactions where the protection buyer purchases exposures outside their core lending/business activity, for the sole purpose of writing credit protection on them (i.e. securitising them) and arbitraging on the yields resulting from the transaction*".