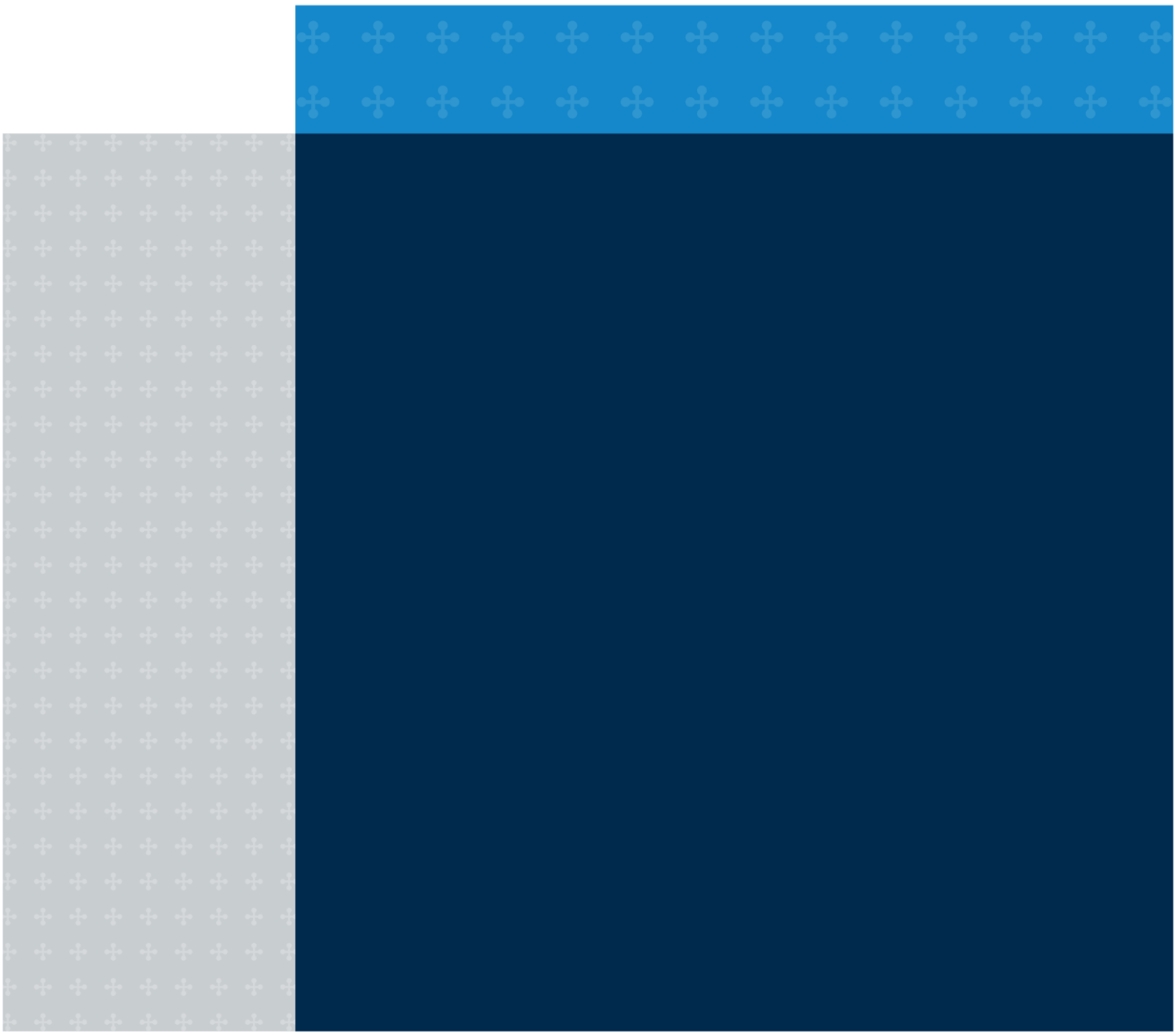
BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Publication

Policy Statement | PS24/21

# Implementation of Basel standards: Non-performing loan securitisations

October 2021



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Policy Statement | PS24/21

# Implementation of Basel standards: Non-performing loan securitisations

October 2021


Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

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# 1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 10/21 'Implementation of Basel standards: Non-performing loan securitisations'.[1] It also contains the PRA's final policy, as follows:

- a new Non-Performing Exposures Securitisation Part of the PRA Rulebook (Appendix 1); and
- an updated Supervisory Statement (SS) 10/18 'Securitisation: General requirements and capital framework' (Appendix 2).

1.2 This PS is relevant to UK banks, building societies, and PRA-designated investment firms (collectively, 'firms'), as well as UK financial holding companies (FHCs) and UK mixed financial holding companies (MFHCs) of certain PRA-authorised firms.

## Background

1.3 In CP10/21, the PRA consulted on:

- draft rules for calculating capital requirements on exposures to Non-Performing Exposure (NPE) securitisations; and
- new supervisory expectations regarding NPE securitisations.

## Summary of responses

1.4 The PRA received one written response to the CP and additional verbal comments in a discussion with industry representatives during the consultation. Respondents welcomed the PRA's development of an NPE securitisation framework, but made a number of observations and requests for clarification, which are set out in Chapter 2.

## Changes to draft policy

1.5 Where the final rules differ from the draft in the CP in a way which is, in the opinion of the PRA, significant, the Financial Services and Markets Act 2000 (FSMA) requires the PRA to publish:[2]

(a) details of the difference together with a cost benefit analysis; and

(b) a statement setting out in the PRA's opinion whether or not the impact of the final rule on mutuals is significantly different to the impact that the draft rule would have had on mutuals, or the impact that the final rule will have on other PRA-authorised firms.

1.6 The PRA has made one change to its draft rules in the CP.

1.7 The definition for NPE securitisation within the draft rules has been amended such that the words 'or any other relevant reason' are excluded from the definition. The definition now reads 'NPE securitisation means a securitisation 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 or restructuring'.

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1 June 2021: CP10/21 'Implementation of Basel standards: Non-performing loan securitisations'.
2 Section 138J(5) and 138K(4).

1.8 The PRA made this change to the definition in response to respondents' concerns. The PRA considers that this change will reduce uncertainty (see 'Definition of NPE securitisation' in Chapter 2), will not have a significant impact on firms, and will not have a significantly different impact on mutuals than for other firms. As a result, the cost benefit analysis has not been updated in light of this change.

1.9 The PRA has also made minor changes to SS10/18 to reflect the UK's withdrawal from the EU, and improve clarity of drafting.

1.10 When making Capital Requirements Regulation (CRR) rules, the PRA must consider, and publish an explanation of, the ways in which the PRA has had regard to the additional matters and how the additional 'have regards' have affected the proposed rules.[3] In CP10/21, the PRA set out this explanation in Chapter 3, and below the PRA has provided an updated explanation of the 'have regards' to take into account consultation responses.

1.11 In relation to the change noted above, the PRA has updated its consideration of its primary and secondary objective and 'have regards'.

1.12 The PRA considers that this change to its draft rules has not had a material impact on its primary objective. In terms of proportionality, the PRA considers that the burden placed on firms by the proposed definition as consulted on was not proportionate to any benefit gained by the definition. The PRA has had regard to the relevant standards recommended by the Basel Committee on Banking Supervision (BCBS), the effect of the rules on the relevant standing of the UK as a place for internationally active credit institutions and investment firms to be based or to carry on activities, and the likely effect of the rules on the ability of CRR firms to continue to provide finance to businesses and consumers in the UK on a sustainable basis in the medium and long term. The PRA considers that while amending the definition of NPE securitisations is a small deviation from the standards recommended by the BCBS, the amended definition is consistent with the relative standing of the UK and the competitiveness of the UK while also better supporting finance to the real economy.

1.13 The PRA must also publish a summary of the purpose of the proposed rules.[4] The purpose of the rules is to specify the capital treatment for NPE securitisations. The rules set out the approach for the calculation of risk weighted assets for NPE securitisations.

## Implementation

1.14 The updated SS10/18, and the rules for calculating capital requirements on exposures to NPE securitisations, will take effect from Saturday 1 January 2022. This will take effect in conjunction with a consequential amendment to the CRR by HM Treasury before 1 January 2022.

1.15 The PRA will keep this policy under review and in this regard welcomes additional submissions of evidence from firms regarding NPE securitisations.

1.16 References related to the UK's membership of the EU covered by the policy in this PS have been updated as part of this PS to reflect the UK's withdrawal from the EU. Unless otherwise stated, any remaining references to EU or EU-derived legislation refer to the version of that legislation which forms part of retained EU law.[5]

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3 Sections 144C(1)(2) and 144D(1) of FSMA.
4 Section 144D(2) of FSMA.
5 For further information please see Transitioning to post-exit rules and standards.

## 2 Feedback to responses

1.17 Before making any proposed rules, the PRA is required by FSMA to have regard to any representations made to it, and to publish an account, in general terms, of those representations and its feedback to them.[6]

1.18 The PRA has considered the responses received to the CP. This chapter sets out the PRA's feedback to those responses, and its final decisions.

1.19 The responses have been grouped as follows:

- Definition of NPE securitisation;
- Non-refundable purchase price discount (NRPPD) requirement for qualifying NPE securitisations;
- Risk weight treatment for NPE securitisation positions;
- Supervisory expectations of Senior Management Function (SMF) 16;
- Foundation internal ratings based (IRB) approach; and
- Responses not related to the CP proposals.

### Definition of NPE securitisation

1.20 CP10/21 proposed to include, in the definition of an NPE securitisation, a requirement to recalculate the percentage of the nominal value of non-performing exposures in the underlying pool backing the securitisation at any later time where assets are added to or removed from the underlying pool due to 'any other relevant reason'. The PRA received three responses to this proposal including verbal comments in a discussion with industry representatives.

1.21 The respondents were concerned that the proposed requirement would generate significant uncertainty among market participants. It was not clear to the respondents what 'any other relevant reason' would be beyond replenishment or restructuring, which is already included in the definition.

1.22 After considering the response, the PRA has decided to amend its definition of NPE securitisation to remove the wording that was generating uncertainty to market participants. The PRA considers that this change is proportionate as it addresses the concerns raised without material adverse effect on safety and soundness.

### NRPPD requirement for qualifying NPE securitisations

1.23 CP10/21 proposed to define a qualifying NPE securitisation as a traditional NPE securitisation, where the NRPPD is at least 50% of the outstanding amount of the underlying exposure at the time they were transferred to the securitisation special purpose entity (SSPE). The PRA received one response to this proposal.

1.24 The respondent suggested that the NRPPD minimum requirement be lowered to 20%, in order to maintain alignment with the provisioning requirement that defaulted exposures must meet in

6 Sections 138J(3) and 138J(4) of FSMA.

order to receive a 100% risk weight (RW) under the standardised approach (SA)[7] to credit risk in the CRR.[8]

1.25 Having considered this response, the PRA has decided to maintain its proposed approach. This requirement follows from the Basel standard. It is calibrated in light of a number of considerations, including data on existing NPE securitisations, deductions from Common Equity Tier 1 (CET1) for insufficient coverage of non-performing exposures,[9] and parameters for loss given default (LGD).[10] Given these considerations, and in the absence of other evidence supporting a lower NRPPD, the PRA considers it appropriate to keep the minimum NRPPD requirement for qualifying NPE securitisations at 50% to help ensure the safety and soundness of firms.

### Risk weight treatment for NPE securitisation positions

1.26 CP10/21 proposed a fixed RW of 100% for the senior tranche of qualifying NPE securitisations, and a 100% RW floor for all NPE securitisations calculated through the securitisation internal ratings based approach (SEC-IRBA), securitisation standardised approach (SEC-SA), or look-through approach. The PRA received six responses to this proposal including verbal comments in a discussion with industry representatives.

1.27 One respondent suggested that the fixed RW of 100% for the senior tranche of qualifying NPE securitisations should instead be a ceiling. They thought that the PRA's proposed 100% fixed RW may mean that the senior tranche of an NPE securitisation has the same RW as the underlying exposure, despite the credit enhancements a securitisation structure adds, and that a fixed RW does not reflect the improved credit quality of the senior tranche over time. The respondent expressed concern that the sample of NPL securitisations reviewed by the BCBS in developing the Technical Amendment on NPL securitisations may have been skewed towards securitisations with underlying pools comprised of loans from countries with low sovereign risk ratings and relatively more difficult loan enforcement processes.[11]

1.28 Having considered this response, the PRA has decided to maintain its proposed approach. The PRA considers that a 100% fixed RW for the senior tranche of qualifying NPE securitisations aligns with the SA RW for exposures in default, and is consistent with the PRA's safety and soundness objective. In CP10/21, the PRA invited evidence that a RW floor below 100% for the senior tranche of qualifying NPE securitisations is compatible with the PRA's primary objective on safety and soundness. Respondents did not provide relevant evidence.

1.29 Two respondents suggested that the proposed 100% RW floor for all tranches of NPE securitisations calculated through the SEC-SA, SEC-IRBA, or look-through approaches was not appropriate. These respondents thought that the senior tranche of an NPE securitisation would frequently have the same RW as the underlying assets, despite the securitisation structure adding significant liquidity and credit enhancement. They therefore also thought that in the UK it was possible to achieve a high rating for the senior and non-senior tranches of NPE securitisations, which would lead to a RW below 100% under SEC-ERBA.

1.30 Having considered the responses, the PRA has decided to maintain its proposed approach. Given the intrinsic complexity of securitisations and unique nature of NPE securitisations with the

7 CRR Article 127.
8 The onshored and amended UK version of Regulation (EU) No 575/2013.
9 CRR Article 47c.
10 CRR Article 161.
11 Technical Amendment on NPL securitisations.

underlying securitised exposures being non-performing, the PRA considers this to be in line with its safety and soundness objective.

1.31 Two respondents suggested that if an NPE securitisation's underlying exposures have state credit protection, the fixed risk weight of 100% for the senior tranche of qualifying NPE securitisations would be overly conservative.

1.32 Having considered these responses, the PRA has decided to maintain its proposed approach. The PRA proposed a definition for, and treatment of, NPE securitisations in order to provide a framework that is appropriately calibrated for securitisations of NPEs. In having regard to the principle that PRA rules should apply a burden proportionate to their expected benefit, the PRA considers its overall approach to be appropriate. The PRA notes that it is able to waive or modify rules under section 138A of FSMA where a firm can demonstrate to the PRA's satisfaction that the application of the unmodified rule would impose an undue burden on a firm, or would fail to achieve its intended purpose, and where modifying it would not adversely affect the advancement of the PRA's objectives.

1.33 One respondent suggested that the UK should consider adopting the EU approach such that expected loss pursuant to Articles 267 (look-through approach) and 268 (maximum capital requirements) is on a basis net of NRPPD for qualifying NPE securitisations. The respondent expressed concerns that the EU approach may create a competitive advantage for an EU investor as compared to a UK investor.

1.34 Having considered this response, the PRA has decided to maintain its proposed approach. In CP10/21, the PRA invited firms to provide evidence that an approach net of NRPPD for methods within Articles 267 and 268 is compatible with the PRA's primary objective of safety and soundness. As respondents did not provide any evidence, the PRA considers that there is insufficient evidence to determine that the approach would be in line with safety and soundness.

### Supervisory expectations of SMF 16

1.35 One respondent did not believe there was a valid rationale to amend SS10/18 so that SMF 16s 'should satisfy themselves that performing loans are not being included in an NPE securitisation for the purpose of reducing the capital charge on such loans', as proposed in the CP. The respondent thought that this expectation would add further complexity to an 'already vast and wide-ranging set of rules'.

1.36 Having considered the response, the PRA has decided to maintain its proposed approach. Given the relatively new NPE securitisation framework and lack of experience of securitising NPE exposures by firms, the PRA considers the application of this expectation to be in line with its safety and soundness objective, and not overly burdensome.

### Foundation IRB approach

1.37 One respondent supported the PRA's proposal to preclude firms from applying the SEC-IRBA approach to NPE securitisations, where a firm applies the IRB approach to any exposures in the pool of underlying exposures, but does not use own estimates of LGD and conversion factors (the Foundation IRB approach).

1.38 One respondent queried if there was a deliberate difference between the drafting of the PRA rules, the EU CRR, and the BCBS text with regard to the use of the Foundation IRB approach for the maximum capital approach.[12] The PRA considers that its proposals were clear, particularly in its

12 Article 268 of CRR.

expectation that the Foundation IRB approach is excluded for use within the maximum capital approach for NPE securitisations.

## Responses not related to the CP proposals

### Prudential backstop

1.39 One respondent queried whether NPE securitisations could be excluded from the CET1 deductions requirement for insufficient coverage of NPE exposures ('prudential backstop').[13] Another respondent queried whether traditional NPE securitisations that have achieved significant risk transfer could be excluded from the prudential backstop.

1.40 The PRA clarifies that a firm may exclude the securitised exposures from traditional securitisations that meet the conditions for either significant risk transfer[14] or achieve de-recognition under the applicable accounting framework as defined in the CRR from the prudential backstop requirements. The firm should apply the prudential backstop requirements to any retained exposure.

### Securitisation regulation

1.41 Two respondents did not consider capital calibrations within CP10/21 sufficient to facilitate the securitisation of NPEs in light of barriers within the Securitisation Regulation, particularly within risk retention and credit granting requirements.[15] The PRA considers that any amendment to the Securitisation Regulation is outside the scope of CP10/21, but plans to share these responses with the Financial Conduct Authority and HM Treasury.

### Re-performing loans

1.42 One respondent believed there are similar issues concerning the capital requirements for re-performing loan securitisations as there are for the capital requirements of NPE securitisations. The PRA considers performing or re-performing loans outside the scope of CP10/21.

### Specific credit risk adjustments

1.43 Three respondents asked for clarification on whether assets bought at a discount to par value would have that crystallised loss recognised as a specific credit adjustment, and if not whether onshored EU/183/2014 could be amended to account for this. The PRA considers that the regulatory framework is clear in respect of assets bought as a discount to par value, and that amending onshored EU/183/2014 is outside the scope of CP10/21.

13 Article 47c of CRR.
14 Article 244(2) of CRR.
15 Onshored Regulation (EU) 2017/2402.

## Appendices

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|---|---|
| 1 | **SS10/18 'Securitisation: General requirements and capital framework', available at: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/securitisation-general-requirements-and-capital-framework-ss** |
| 2 | **CRR FIRMS: NON-PERFORMING EXPOSURES SECURITISATION (CRR 2 MODIFICATIONS) INSTRUMENT 2021, available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2021/october/ps2421app2.pdf** |