BRIEFING
EU Legislation in Progress

Credit servicers, credit purchasers and the recovery of collateral

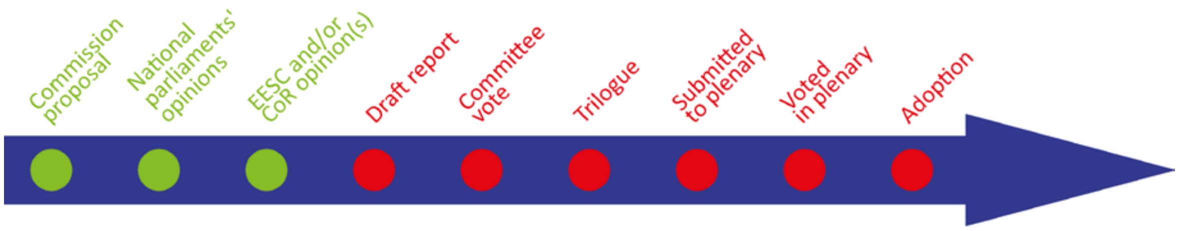
Fostering secondary markets for non-performing loans (NPLs) and easing collateral recovery

OVERVIEW

Due to the recessions brought about by the financial crisis from the end of the past decade, more and more EU companies and citizens have faced economic difficulties in recent years and have been unable to repay their loans. As a consequence, many EU banks have accumulated high volumes of non-performing loans (NPLs) in their balance-sheets. Although almost halved in comparison to December 2014, the ratio between NPLs and the total loans extended by EU banks (NPL ratio) remains historically high when measured against the ratios of other advanced economies. High levels of NPLs require banks to hold higher amounts of regulatory capital and pay a risk premium on liquidity markets, as a result of which their profitability and growth prospects diminish. To tackle this issue, a number of different initiatives have been adopted both at national and EU level. Within this context, in March 2018 the Commission adopted a comprehensive package of measures including a proposal for a directive aimed at fostering NPL secondary markets and easing collateral recovery from secured loans.

Proposal for a directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral

Committee responsible:	Economic and Monetary Affairs (ECON)	COM(2018) 135
Co-rapporteurs:	Esther de Lange (EPP, Netherlands); Roberto Gualtieri (S&D, Italy)	14.3.2018 2018/0063(COD)
Shadow rapporteurs:	Bernd Lucke (ECR, Germany); Ramon Tremosa i Balcells (ALDE, Spain); Dimitrios Papadimoulis (GUE/NGL, Greece); Ernest Urtasun (Greens/EFA, Spain); Marco Zanni (ENF, Italy)	Ordinary legislative procedure (COD) (Parliament and Council on equal footing – formerly 'co-decision')
Next steps expected:	Publication of draft report	



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Author: Carla Stamegna
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Introduction

When the borrower has not made a scheduled payment for a loan over a certain period of time, or is likely to be unable to fully repay it, a loan becomes 'non-performing'. Due to the recessions provoked by the financial crisis from the end of the past decade, more and more EU citizens and companies have been experiencing economic difficulties, or even faced bankruptcy, and have therefore been unable to repay their loans. This has been particularly the case in EU Member States that have faced prolonged periods of recession. As a consequence, many banks have accumulated high volumes of non-performing loans (NPLs) on their balance sheets.

According to some commentators, excessive stocks of NPLs can limit banks' lending ability, and even impair the monetary policy transmission mechanism, while others argue that this proposition does not rest on solid theoretical or empirical ground. What is acknowledged is that NPLs are heterogeneous assets of an illiquid nature, that their value is difficult to identify and that they do not normally generate stable returns. Therefore, high levels of NPLs require banks to hold higher amounts of regulatory capital and pay a risk premium on liquidity markets, which reduces their profitability and growth prospects.

To tackle this issue, a number of different initiatives have been adopted at both national and EU level (see below, 'Preparation of the proposal'). In the context of this significant momentum, in March 2018 the Commission adopted a package of measures, including a proposal for a directive aimed at fostering NPL secondary markets and easing collateral recovery from secured loans.

Context

NPLs are commonly defined as loans that are either more than 90 days past due, or are unlikely to be fully repaid. Closely related to this concept is that of non-performing exposures (NPEs), a more comprehensive term that also includes other debt instruments such as advances, debt securities and off-balance-sheet items. Despite these differences, the two terms are often used as synonyms.[1]

According to European Banking Authority (EBA) data, in June 2016 EU banks held approximately €1 trillion worth of NPLs, equal to 5.5 % of total loans. Two years later (June 2018), this percentage (NPL ratio) had fallen to 3.6 %, thanks to both a reduction in the gross amount of NPLs and an increase in loans. Although almost halved in comparison to the 6.4 % recorded in December 2014, EU banks' NPL ratio remains at historically high levels in comparison to the NPL ratios of other advanced economies (about 1.0 % for both the US and Japan at the end of 2017, according to the World Bank).

Structural impediments hamper a faster decrease in EU NPL stocks. So far, banks have generally sought to manage NPLs within dedicated loan workout units, which rarely operate entirely separately from loan origination units. It is aknowledged however that NPL workout entails a combined financial and operational restructuring that requires an engagement similar to the management of an equity position, and very different skills from those needed to extend credit to financially sound borrowers. More critically, the banks that originated loans do not have sufficient incentives to impose loan restructuring on borrowers, since this usually requires substantial write-downs of borrowers' claims, potentially hindering the future relationship between the banks and their clients.

These inherent constraints explain the ever-increasing interest of banks in selling distressed assets to specialised investors operating in the secondary loans market. This market refers to the sale of loans that occurs after such loans have been originated on the primary market, where lenders lend directly to borrowers. It includes both sales or trades of the original loans made by lenders, and those made by subsequent purchasers.

Placing greater emphasis on market-based solutions is seen as essential in an effort to level out persistent asset quality problems in banks' balance-sheets. First of all, such solutions increase efficiencies in loan servicing and workout thanks to economies of scale, as the assets of several lenders are combined, and to economies of scope, as different asset types are handled. Second, good skilled workout professionals will take on the financial and operational restructuring of distressed-but-still-viable debtors, increasing the proportion of a bad debt value that can be recovered (recovery rate). Third, the sale of a loan overcomes the inherent incentive problem of banks related to their efforts to restructure loans while developing new forms of business. Last but not least, the benefits to the divesting banks result from the reduction of risk-weighted assets in those cases where possible write-down losses borne by banks when selling loans are lower than the additional regulatory capital they should set aside if the NPLs were managed internally.

However, potential market failures may affect distressed loans sales. Such failures include:

- **A concentrated investor base**. Investors in certain types of assets bear considerable sunk costs specific to each transaction, while the outcome of the bidding process is uncertain. Only a few investors have the ability to submit repeated bids on different European markets. This may result in them having power over pricing.
- **Information asymmetry**. The banks that originated the loans are generally unable to provide a complete and credible picture of asset quality. As a consequence, buyers will suspect that the assets they are bidding for are of low quality, and will bid at a correspondingly low price. At the same time, the originating bank, which is able to distinguish between low- and high-quality assets, will trade only on the former. That might lead to an adverse selection problem.

These circumstances have contributed to a significant difference between the prices offered by investors when purchasing loans and those demanded by banks when selling them ('bid-ask spread'), which is a typical feature of secondary loans markets.

Ineffective legal frameworks for the recovery of debts and enforcement of collateral may also lead to information asymmetry problems and limit demand on loan markets. The time required to recover a credit can be prohibitively long and unpredictable. Distressed debtors may know that collateral cannot be enforced easily or quickly and will at times not cooperate with their creditors. That has a negative impact on the possibility to make accurate estimates of the future cash flows expected from NPLs; as a result, these are heavily discounted and the corresponding asset price is reduced. In this vein, investors will take into account the expected workout time when valuing assets in order to purchase and penalise those in jurisdictions where legislation is least effective.

Existing situation

As explored in a 2016 Bruegel report for the Commission, on developments in EU capital flows, the EU secondary loans market is clearly under-sized. In 2016, the loans transacted in European markets reached a gross value of about €146 billion, including a significant share of performing loans. Transparency in these markets remains limited: while banks have an incentive to report on disposal of non-performing assets, the valuation in the market and the additional write-down that is required rarely become public. These markets are characterised by a clear prevalence of assets that are secured against commercial and residential real estate. Such assets account for slightly over 60 % of all transactions (including in performing assets), showing that investors do not feel comfortable with corporate debt that is not secured by any collateral offering a reasonably clear path to enforcement. Hence, the 'best-seller' NPL portfolios appear to be those where servicers can largely rely on recovery of collateral and enforcement with household and corporate borrowers. By contrast, the acquisition of sub-performing loans extended to enterprises that require restructuring, is rare.

In December 2016, in relation to the activity carried out within the Single Supervisory Mechanism (SSM), the European Central Bank (ECB) collected data from the national competent authorities of the EU Member States that are in the euro area, confirming that these Member States do not have a developed NPL market, with the exception of Spain and Ireland, where the market is flagged as being in a 'medium' state of development. Similarly, markets in most non-euro area Member States, except for the UK, are small and underdeveloped. The ECB survey shows that the regulatory framework in all participating countries allows banks to outsource NPL loan-servicing activities. However, this practice remains uncommon in many Member States.

As flagged by many respondents to the public consultation launched by the Commission ahead of the adoption of the legislative proposal, significant differences persist in the way legal foreclosures, insolvency procedures, consumer protection laws as well as out-of-court procedures are applied across the EU. In many Member States, out-of-court enforcements or sales involve lengthy notification periods, and in many cases debtors have the possibility to delay the process through legal action. Some Member States do not have small claims courts, which decreases the efficiency of the legal procedures for credit recovery while also lengthening the collection term and cost. In certain Member States, the length of insolvency proceedings differs considerably depending on the court having jurisdiction to handle them. In addition, real-estate valuations made in connection with secured NPL securitisations have a high level of uncertainty, partly due to the illiquid nature of the assets securing the loans. This uncertainty is compounded by lengthy recovery procedures.

Overall, these substantial and procedural differences among national legal systems make it difficult for cross-border investors to realise economies of scale from cross-border activity. On reflection, banks wishing to dispose of their NPLs face an investor base fragmented along national borders; furthermore, servicers cope with significant obstacles when trying to automate and standardise credit servicing involving a cross-border dimension.

Parliament's starting position

In its annual report on the banking union in 2016, the European Parliament considered that reducing high levels of NPLs was crucial, yet noted that hitherto efforts to do so had mainly taken place at national level. While restating the need to solve this issue as soon as possible, it acknowledged that a definitive solution would take time. The Parliament also considered 'that any suggested solution should take into account the source of NPLs, the impact on banks' lending capacity to the real economy, and the need for the development of a primary and secondary market for NPLs, possibly in the form of safe and transparent securitisation,[[2]] that involves both Union and national levels'. In the annual report on the banking union in 2017, the Parliament appreciated the efforts made to reduce the levels of NPLs in EU banks and called on the Commission to take action to speed up the process, for example, by encouraging the creation of dedicated asset management companies ('bad banks') and secondary markets for NPLs. It also noted the need to improve and harmonise the early restructuring and insolvency framework. Furthermore, since mandatory offloading of NPLs in illiquid and opaque markets can cause losses in banks' balance-sheets, the Parliament reiterated its concern regarding the targets set out in the draft addendum to the ECB guidance on NPLs (see below, 'Preparation of the proposal') and reasserted the prerogatives of the EU legislators.

Council starting position

On 31 May 2017, the Council's Financial Services Committee (FSC) Subgroup on Non-Performing Loans submitted its final report on NPLs, in which it analysed the situation of NPLs in Europe and the policies implemented thus far, and proposed to the Council a number of policy options. Based on the recommendations of the FSC report, the ECOFIN Council adopted an action plan to tackle NPLs at its meeting on 11 July 2017. Ministers agreed that the current pace of NPL reduction appeared inadequate, and that even though NPL stocks were concentrated in a number of countries, an integrated EU strategy was required. The Council conclusions endorsed numerous proposals on market functioning (i.e., through the development of a standardised data template for NPLs, and possibly a single transaction platform), better supervision (in terms of strengthened provisioning guidelines and better scrutiny by the European Systemic Risk Board), and also called for a 'blueprint for national asset management companies'.

Preparation of the proposal

On 22 November 2016, the European Commission proposed a directive on insolvency frameworks aiming to facilitate the restructuring of non-performing debt and to give entrepreneurs a second chance. In the context of the mid-term review of the capital markets union action plan, the

Commission acknowledged that well-functioning capital markets could help European banks to overcome the challenges of NPLs. It committed to presenting initiatives to support secondary markets for non-performing loans, possibly by strengthening the framework for collateral recovery and building on its previous initiative to simplify insolvency regimes and restructuring frameworks.

In its May 2017 reflection paper on deepening the economic and monetary union, the Commission stressed the importance of a European strategy for non-performing loans to help address the issue and support national actions.

In its communication of 11 October 2017 on completing the banking union, the Commission committed to adopting a comprehensive package of measures to tackle NPLs by spring 2018. Among these were:

- a blueprint on how national asset management companies (AMCs) can be set up;
- measures to further develop secondary markets for NPLs;
- measures to enhance the protection of secured creditors;
- a benchmarking exercise of loan enforcement regimes to get a reliable picture of the delays banks experience and the value recovery efforts they make when facing borrower defaults;
- a report, accompanied, where appropriate, with the necessary legislative proposals, on the possible introduction of minimum levels of provisioning for future NPLs; and
- a proposal to foster transparency on NPLs by improving data availability and comparability.

On 18 January 2018, the Commission tabled its first progress report on the action plan to tackle non-performing loans proposed by the Council; the report highlights that the positive trend of falling NPL ratios and growing coverage ratios continued into the second half of 2017. The same trend is registered in the second progress report, published in March 2018, and in the third progress report, from November 2018. However, NPL ratios remain uneven across the EU – ranging from 0.6 % to 44.9 % – and slow progress in some Member States remains a source of concern.

As for the supervisory side, the European Banking Authority (EBA) worked to set out a common EU definition of non-performing exposures that banks are encouraged to use, even if it is only binding for supervisory reporting purposes.[3] In January 2017, Andrea Enria, then EBA chairman, presented a proposal for an EU-wide asset management company that could free up EU banks from the burden of NPLs. In March 2017, the ECB published its guidance to banks on tackling non-performing loans, complemented by a draft addendum published on 4 October 2017, which aimed to reinforce the guidance with regard to promoting timely provisioning and write-off practices, and in particular specified quantitative supervisory expectations for minimum levels of prudential provisions for new NPLs. In a letter to the ECB dated 9 October, European Parliament President, Antonio Tajani, raised the question as to what extent could additional obligations be imposed on supervised entities without the appropriate involvement of co-legislators. The then Chair of the ECB Supervisory Board, Danièle Nouy, responded a few days later. In March 2018, the ECB published the final version of the addendum to its guidance, which specifies quantitative supervisory expectations for minimum levels of prudential provisions for newly originated NPLs.

On 14 March 2016, the Commission published a two-part impact assessment (IA) accompanying its legislative proposal. The first part focuses on the development of secondary markets for non-performing loans. The second part focuses on the accelerated extrajudicial collateral enforcement procedure. An initial appraisal carried out by EPRS flags that there seem to be qualitative differences in the way research, analysis and consultation activities were presented in the two parts. The IA on the out-of-court enforcement procedure seems to be overall better substantiated than the one on secondary markets. Overall, it adheres more closely to the Commission's internal better regulation guidelines, for instance, in terms of analysing issues related to effectiveness and efficiency, making quantifications, paying attention to the social impact and to impacts on SMEs.

The changes the proposal would bring

Against the background outlined above, on 14 March 2018 the Commission adopted a comprehensive package of measures to speed up progress already made in reducing NPL stocks and prevent their renewed build-up in the future. The package comprises:

- a proposal for a directive on credit servicers, credit purchasers and the recovery of collateral;
- a proposal for a regulation amending the Capital Requirements Regulation (CRR) by introducing common minimum coverage levels ('statutory backstop') for newly originated loans that become non-performing;
- a Commission staff working document containing a blueprint for the set-up of national asset management companies (AMCs). The document provides non-binding guidance to national authorities on how they can set up AMCs dealing with NPLs.

The proposal for a directive aims in particular to foster the development of secondary markets for NPLs by tackling undue obstacles to credit servicing and to the transfer of bank loans to third parties (credit purchasers) across the EU ('passporting'). The proposal applies to servicers and purchasers of credits originally issued by a credit institution or its subsidiaries, irrespective of the type of borrower concerned. Credit servicers are defined as natural or legal persons, other than a credit institution or its subsidiaries, which carry out one or more of a list of activities referring to the administrative aspects of a loan (Article 3(1)(8)).

Title II establishes a framework for servicers of credit agreements issued by credit institutions, by setting out uniform and harmonised conditions for authorisation (Chapter I) and imposing conduct rules across the EU (Chapter II).

Title III covers credit purchasers. It sets out rules aimed at increasing transparency in the supply side, and accordingly requiring creditors to provide all necessary information to a credit purchaser prior to entering into a contract (Article 13). Furthermore, it mandates the use by credit institutions of data standards provided by the EBA (Article 14). Yet again, it requires purchasers of bank loans to notify authorities when acquiring a loan (Article 16). In order to facilitate the enforcement of the obligations set out in the directive, third-country purchasers of consumer loans are required to operate through authorised EU credit servicers (Article 15). Last but not least, it envisages rules concerning the enforcement of a credit agreement by the credit purchaser directly (Article 18).

Title IV covers the supervision by competent authorities. It sets obligations for the designation of national authorities responsible for the implementation of the directive (Article 20) and specifies their supervisory powers (Article 21).

The proposal also intends to provide banks with a mechanism to accelerate the value recovery from secured loans. In particular, Title V establishes a framework for accelerated extrajudicial collateral enforcement (AECE); this framework is strictly limited to corporate loans and applicable only if prior voluntary agreement between the secured creditor and business borrower has been achieved when concluding the loan contract (Article 23). Member States are then required to have in place at least one procedure commonly used to recover value from collateral, such as a public auction or a private sale, suitable for the purpose of the AECE (Article 24). Borrowers are given the right to challenge the use of this accelerated extrajudicial collateral enforcement procedure before national courts (Article 28). Consumer loans are excluded.

Titles VI and VII include legal safeguards and transparency rules to ensure that the transfer of a loan does not affect the rights and interest of consumers. Title VIII contains final provisions.

This proposal for a directive is presented as reciprocally reinforcing the other measures included in the Commission's package. First, the widespread use of accelerated extrajudicial collateral enforcement (AECE) envisaged in this proposal is expected to incentivise banks to restructure, recover or dispose of their NPLs earlier, so that they would be less affected by the increased provisioning due to the new prudential backstop set out in the proposal for a regulation. Second, on reflexion, the higher provisioning required to keep secured corporate NPLs on balance sheets would incentivise banks to restructure, recover or dispose of NPLs quicker and earlier, and hence to use AECE. Third, better functioning secondary loans markets would reduce the bid-ask spread and increase banks' willingness to transfer their NPLs to specialised investors at an earlier stage, therefore the provisioning backstop would be triggered less often. Finally, more liquid and better functioning secondary markets for NPLs would create additional incentives for credit institutions to use AECE at the origination of new loans, as third party investors would eagerly purchase NPLs having the AECE feature.

Advisory committees

The European Economic and Social Committee (EESC) adopted its opinion on the non-performing loans package on 11 July 2018 (rapporteur: Juan Mendoza Castro (Group II – Workers, Spain)). The EESC welcomes the Commission's package that is seen as key in the EU strategy to address the long-lasting issue of NPLs, and fundamental to progress towards the banking union. However, the advisory body is of the view that regulators must not encourage the sale of NLPs. It also notes that while the out-of-court procedures may be beneficial for the creditor, the solution to the problem of NPLs lies mainly in strengthening judicial procedures across the whole EU.

National parliaments

The proposal was transmitted to the national parliaments on 16 April 2018 with a deadline to submit a reasoned opinion on the grounds of subsidiarity by 11 June 2018. The Portuguese Assembleia da República and the Romanian Senate opened political dialogue with the Commission.

Stakeholders' views[4]

Following the publication of the European Commission's legislative initiatives on NPLs, the Association for Financial Markets in Europe (AFME) considered that access to third-party loan servicers is crucial to the development and growth of secondary markets for NPLs, and that measures to facilitate the provision of cross-border credit servicing activities are a step in the right direction towards a genuine EU market for NPLs. AFME also welcomed the introduction of common standards for supervision of credit servicing activities. However, it pointed out that other major issues that have not been addressed in the Commission's legislative proposal, remain; such issues include ways to facilitate the wider participation of investors or efforts to reduce transfer and registration costs of loan transactions.

While AFME deems that consumers should be protected by guaranteeing the financial expertise of loan servicing providers as well as the suitability of asset recovery practices, the European Consumer Organisation (BEUC) advocates the exclusion of consumer loans from the whole scope of the Commission's proposal. In its view, there are alternative, sustainable ways of addressing the NPL problem while at the same time protecting distressed borrowers. Banks usually sell NPLs to third-party investors at enormously discounted prices. As a minimum, the concerned borrowers should be given the opportunity to purchase their own debt at the discounted price, instead of it being sold to third-parties. The BEUC points out the importance of responsible lending and calls for a restriction of the activity of third-party credit servicers and credit investors. In its opinion, market actors who maximise their profits on the back of vulnerable consumers and businesses should not be supported, but should face restrictions instead.

Similarly, Finance Watch, a not-for-profit association of 48 civil society organisations, believes that well-functioning, transparent and professional secondary markets for NPLs could be an important part of the solution, provided it does not undermine credit standards or lead to aggressive and inappropriate enforcement actions. In its view, harmonised rules for NPL investors and credit servicers should be conducive to this effort.

In responding to the consultation on the proposal for a regulation on statutory prudential backstops for newly originated loans that become non-performing, the European Banking Federation (EBF) pointed out that in the secondary market there are several investors in NPL portfolios that are regulated entities and would therefore have to comply with the proposed amendments to the CRR. These investors make up a sizeable portion of the secondary markets in many Member States, but increased requirements might incentivise them to move away, which does not seem in line with the Commission's intention to expand and improve the NPL secondary market.

Legislative process

On 31 May 2018, Parliament's Committee on Economic and Monetary Affairs (ECON) appointed Esther de Lange (EPP, Netherlands) and Roberto Gualtieri (S&D, Italy) as co-rapporteurs for this file. The ECON committee held a first exchange of views on the NPLs package on 3 September 2018.

The review in the Council's Working Party for Financial Services is ongoing.

EP SUPPORTING ANALYSIS

Initial Appraisal of the Commission IA on the proposal for a directive on Loan servicers and buyers and recovery of collateral, EPRS, November 2018.

Initial Appraisal of the Commission IA on the proposal for a regulation on minimum loss coverage for non-performing exposures, EPRS, July 2018.

New EU insolvency rules give troubled businesses a chance to start anew, EPRS, June 2018.

Common rules and new framework for securitisation, EPRS, January 2018.

Non-performing loans in the Banking Union – Stocktaking and challenges, Directorate-General for Internal Policies, European Parliament, October 2018.

Non-performing loans in the Banking Union: state of play, Directorate-General for Internal Policies, European Parliament, July 2017.

OTHER SOURCES

Credit servicers, credit purchasers and the recovery of collateral, European Parliament, Legislative Observatory (OEIL).

Minimum loss coverage for non performing exposures, European Parliament, Legislative Observatory (OEIL).

ENDNOTES

[1] A common EU definition for non-performing exposures (NPEs) was elaborated by the European Banking Authority (EBA) for the purposes of Commission Implementing Regulation (EU) No 680/2014 (referred to as the 'EBA ITS on supervisory reporting'). It covers loans, advances, debt securities and off-balance sheet items, and is wider than the relevant accounting standards. It builds on the 'more than 90 days past due' criterion and/or on an 'unlikely to pay' assessment, with a list of conditions triggering the 'unlikely to pay' situation. Even if formally binding only for the supervisory reporting requirements set out in Regulation (EU) No 575/2013 (known as the 'Capital Requirements Regulation'), this definition is referred to in several works addressing the NPL issue, including the EBA guidelines and the ECB guidance.

[2] Regulation (EU) 2017/2402 setting a framework for simple, transparent and standardised (STS) securitisation products was adopted by the European Parliament and the Council of the EU in 2017, entered into force on 17 January 2018 and will apply as from 1 January 2019.

[3] See Endnote 1.

[4] This section aims to provide a flavour of the debate and is not intended to be an exhaustive account of all different views on the proposal. Additional information can be found in related publications listed under 'EP supporting analysis'.

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eprs@ep.europa.eu (contact)

www.eprs.ep.parl.union.eu (intranet)

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