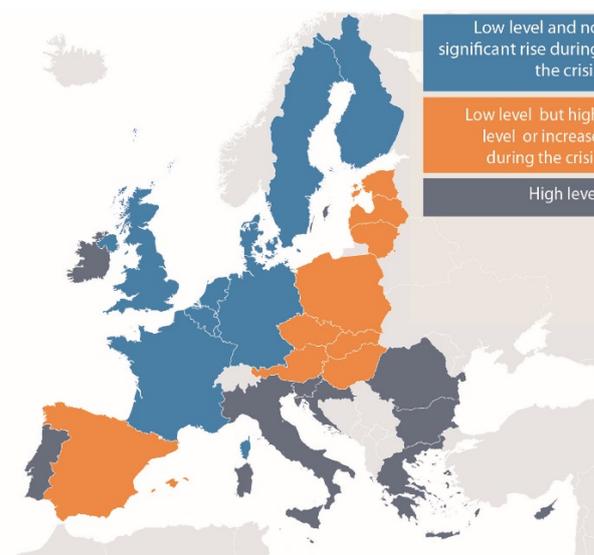


Loan servicers and buyers and recovery of collateral

Impact assessment (SWD(2018)75, SWD(2018)76 (summary)) accompanying a Commission proposal for a directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral (COM(2018)135

This briefing provides an initial analysis of the strengths and weaknesses of the European Commission's impact assessment (IA) accompanying the above [proposal](#), submitted on 14 March 2018 and referred to the Committee on Economic and Monetary Affairs (ECON). The IA is made up of two parts, in practice constituting two separate impact assessments. The [first](#) (IA1) focuses on the development of **secondary markets** for non-performing loans (NPL). The [second](#) (IA2) focuses on the accelerated extrajudicial collateral **enforcement tool**.

Non-performing loans: a European problem



Source: European Commission.

The context is explained in the same way in both IAs. As shown on the map, in a number of Member States banks own non-performing loans, i.e. loans which are not repaid. This problem has repercussions throughout the European Union (EU). Third countries, such as the United States and Japan, have taken action to reduce the level of non-performing loans.

Both IAs focus on secured loans, which are guaranteed by some form of collateral. This collateral is a guarantee of repayment and may be, for instance, equipment, in the case of a company obtaining a loan, or a house in the case of a household getting a mortgage. These loans are usually bought by investment funds and asset managers, known as 'credit purchasers'. Third-party loan

servicing companies perform activities on behalf of creditors, such as monitoring the performance of credit, and enforcing rights and obligations. They are also known as credit servicers. Collectively, entities such as loan servicers and buyers constitute the secondary market, as opposed to the primary market, made up by banks and initial borrowers, such as companies and households.

This proposal is part of a comprehensive package of measures aiming to solve the problems posed by non-performing loans outlined in the [Council action plan](#) to be implemented by different institutions and organisations. One such legislative measure, the Commission proposal on minimum loss coverage for non-performing exposures (i.e. loans), was accompanied by another IA.¹ The latest European Parliament [resolution](#) on the banking union (P8_TA(2018)0058), reiterates the call previously expressed to find solutions to the problem of non-performing loans in Europe, including by developing secondary markets (points 7 and 8).²

Problem definition

Secondary markets — The main problem analysed in IA1 is the under-developed secondary market for non-performing loans in Europe, broken down into two strands. Firstly, there is low demand to purchase non-performing loans in the EU. A limited number of **loan buyers** act in a market with low competition, focusing on a few large transactions clustered in four countries: Spain, Ireland, Italy and the UK. The top 10 buyers in the EU are from America: nine from the US and one from Canada (IA1, p. 16). Three in four investors bought non-performing loans in just one country (IA1, p. 21).

Secondly, the IA says that **loan servicers** are also often active in only one Member State and that there are just a few of them. It states that 20 out of the 47 financial groups active in the EU that provide loan services work in just one EU country (IA1, p. 125). However, 170 **servicing companies** are listed in the EU (IA1, p. 129). The IA argues that the two strands are interconnected: there are just a few loan buyers because they cannot rely on a developed loan servicing market.

The drivers revolve around high costs for both loan buyers and servicers and different legal provisions for both. While the IA says that the scale of costs should be manageable for these kinds of companies, it stresses that both loan buyers and servicers would need to adapt their business models to the legal regime in each Member State in which they operated. Currently they do not do that, or not sufficiently.

Out-of-court enforcement tool — The main problem analysed in IA2 is that banks are unable to recover collateral value effectively, swiftly and uniformly across the EU, when business borrowers default on secured loans. This problem is substantiated by evidence.

Two drivers are defined in the IA, but only one is in scope, namely that out-of-court collateral enforcement mechanisms in the EU are either absent, inefficient or fragmented. This cause is backed up by evidence. In particular, almost half of Member States do not have a mechanism to realise immovable assets, although this is in place in Germany, France, Italy, Spain and the UK, for instance (IA2, pp. 97-100). The inefficiency of the court system in some Member States is outside the scope of the IA, but further explanations on why this has been excluded would have been welcome.

Objectives of the initiative

Table 1: Description of the initiative's objectives in the two IAs under review

Objectives	IA wording (author's emphasis added)
General	<p>Secondary markets</p> <p>The general objectives <u>of the non-performing loans package</u> are to:</p> <ul style="list-style-type: none"> • Limit risks to financial stability by reducing the stock of NPLs in the European banking system and by avoiding the build-up of NPLs in the EU banking system in the future • Support of <u>stable</u> financing to the economy and therewith economic growth <p>Out-of-court enforcement tool</p> <ul style="list-style-type: none"> • Reduce future levels of secured NPLs in banks' balance sheets • Facilitate <u>more lending</u> to corporates and <u>at lower cost</u>, including on a cross-border basis
Specific	<p>Secondary markets</p> <ul style="list-style-type: none"> • Stimulate demand for NPLs by generating a larger investor basis, and consequently also greater competition among investors • Complementary increase in the capacity of loan servicing firms to absorb rising demand for their servicers from more loan sales by NPL investors <p>Out-of-court enforcement tool</p> <ul style="list-style-type: none"> • Enable secured creditors to effectively and swiftly recover collateral value in a standardised way across the EU when business borrowers default on secured loans

Operational or more detailed	<p>Secondary markets</p> <ul style="list-style-type: none"> • Addressing failures in national NPL [secondary] markets by: <ul style="list-style-type: none"> (i) facilitating market entry of NPL investors and loan servicers in Member States with high NPLs and material obstacles to market entry; and (ii) fostering the entry of smaller firms so that smaller banks have a higher chance of finding counterparts in NPL transactions. • Fostering a single NPL [secondary] market: <ul style="list-style-type: none"> (iii) [through] equal treatment across markets in Member States, allowing loan servicers to realise scale economies from cross-border operation; [and by] (iv) enhancing competition through the entry of foreign firms. • Safeguard for borrower rights: <ul style="list-style-type: none"> (v) ensure efficient supervision... to prevent misconduct of NPL purchasers or loan servicers vis-à-vis borrowers; (vi) cost of adjustment of laws that protect borrower rights: to ensure that borrower rights are not undermined by a change in the authorisation rules. <p>Out-of-court enforcement tool</p> <ul style="list-style-type: none"> • Assuring the existence of out-of-court enforcement mechanism governed by the same principles in the whole EU
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Source: Commission IA1 and IA2, author.

The following conclusion may be drawn from the table above.

- The general objectives stated in the two IAs are coherent overall. However, there are some slight nuances, for instance a focus on *stable* financing in the IA on secondary markets, as opposed to *more financing at a lower cost* in the one on the out-of-court tool.
- The specific objectives of the two IAs are complementary, focusing as they do on the demand side of non-performing loans and on the recovery of collateral.
- The more detailed objectives are defined in a broad way in the IA on secondary markets and in a narrow way in the other one. The IA for the out-out-court enforcement tool sets as its only operational objective the achievement of an enforcement mechanism governed by the same principles in the whole of the EU. On the contrary, the IA on secondary markets sets six detailed, and, taken together, seemingly ambitious objectives.

Range of options considered

Secondary markets

The IA compares three main alternatives to the status quo and does not select a single preferred one, arguing that this will require 'political considerations' (IA1, p. 58). Options 2 and 3 are the best, according to the analysis (see bold below). The idea of establishing an information platform to register national rules was discarded at an early stage (IA1, p. 42). The main options analysed are defined with a promising matrix system, relying on 10 dimensions relating to loan purchasers' and loan servicers' authorisation and business rules, as well as three additional dimensions relating to borrower rights (IA1, pp. 38-39). If properly followed-up, this matrix system would have allowed one to compare among a broad range of options. The IA, however, compares just the following three main strategic alternatives.

Option 1 — Non-binding common principles for non-performing loans' investors and loan servicers: non-binding common high-level principles would be defined on a narrow range of subject matters, possibly through non-legislative measures, such as guidelines.

Option 2 — **Binding common minimum standards with passporting**: Member States would transpose binding common minimum standards on a range of subject matters broader than under

Option 1. Operators complying with these standards in one Member State would have a right to provide services elsewhere in the EU ('passport'). A directive would be a suitable instrument.

Option 3 — **Single rulebook and common market supervision**: Member States would introduce *harmonised standards* broadly speaking on the same subject matters as under Option 2, plus supervision. However, Member States could not set higher standards (known as 'gold-plating'). A regulation would be a suitable instrument.

Out-of-court enforcement tool

The IA describes the following five options at length and in a balanced way. The Commission's preferred option is indicated in bold below.

Option 1 — Non-regulatory action based on existing international harmonisation initiatives: the Commission would recommend that Member States adopt best practices in the field.

Option 2 — **Accelerated Extrajudicial Collateral Enforcement (AECE)**: minimum harmonisation - all Member States would be required to provide for an out-of-court collateral enforcement procedure for secured loans; detailed implementation would be established in national law. The parties could use this tool by voluntary agreement. A directive would be a suitable instrument.

Option 3 — Accelerated Loan Security (ALS): creation of a new EU security right together with a fully harmonised out-of-court enforcement procedure. Member States would have no discretion on details and would have to harmonise key legal provisions. Here too, the parties would have the option to use this mechanism by voluntary agreement. A regulation would be a suitable instrument.

The following options were discarded at an early stage: Option 4: an EU out-of-court enforcement mechanism to work alongside existing national regimes, thereby establishing a 29th regime. Option 5: harmonisation of *judicial* collateral enforcement procedures.

Scope of the impact assessment

Secondary markets — The IA analyses all options, notably according to their effectiveness in achieving the objectives and their efficiency and draws the following conclusions.

Table 2: Summary of options and their effects

Criterion	Baseline	Option 1 – Non-binding common principles	Option 2 – Binding common principles with passport	Option 3 – Single rulebook and common market supervision
Effectiveness	0	+	++	+++
Efficiency	0	+	++	++
Coherence	0	+	++	++
Proportionality	0	+	+++	++

Source: Commission, author.

According to the table above, Option 2 is less effective (++) than Option 3 (+++), but is more proportionate. However, the methodology to translate the scores for the assessment criteria into overall ranking (IA1, pp. 110-111) raises some questions relating to effectiveness and efficiency. This requires some explanation. Firstly, the IA concludes that all options would have overall *positive* impacts on markets (detailed objectives i to iv above) and *negative* impacts on borrowers (detailed objectives v and vi). Secondly, there is a progression in the scoring from option 1 (+ and -), through 2 (++ and --), to 3 (+++ and ----) (IA, tables 6, 7 and 8, pp. 48, 50 and 54).

Then, firstly the IA states: 'An overall ranking of effectiveness was derived by averaging the sum of plusses for investors and servicers' (IA1, p. 111). Note that the IA averages the plusses, not the minuses. However, the IA states that safeguarding borrowers' rights and ensuring efficient supervision, where the 'minuses' appear, are among the IA's objectives. Therefore, it is not clear why they are not taken into account to score the effectiveness of the options. This appears to be a

methodological weakness. The IA is adamant about consumer protection, as it states: 'these measures should not decrease the level of consumer protection, as the negative consequences of such a decrease could entail social and financial costs that might outweigh the possible benefits' (IA1, p. 29). Therefore, it seems that the IA should have included the 'minuses' in the effectiveness scoring and explain better how these negative effects would have been mitigated.

Secondly, the IA also states: 'Efficiency is the difference of effectiveness and the average sum of minuses for investors and servicers.' (IA1, p. 111). However, these 'minuses for investors and servicers' do not seem to be a cost for investors and servicers, but for borrowers and supervisors, according to the IA analysis. This also seems to be a methodological weakness. The IA appears to conclude that options are efficient because they would produce a welfare shift from borrowers and supervisors to the benefit of investors and loan servicers. This would seem to go against the Commission policy on consumer protection reiterated in the IA.

Leaving these two important questions aside, the IA is otherwise a knowledgeable and technical analysis of economic impacts. Nevertheless, firstly, the main IA report, excluding the annexes, analyses the impact of the options on a narrow set of stakeholders – mainly two: investors and loan servicers. Secondly, the legal and economic impact on supervision could have been analysed in more depth. Moreover, the negative impact on borrowers is a social impact that could have been analysed further. For instance, what does it mean *in practice* that 'some negative impacts on the borrowers' welfare could result from... misconduct from loan servicers...?' (IA1, p. 49). Against this background, firstly, the IA could have better explained the actual safeguards, i.e. the mitigating measures, planned. Secondly, it could have expanded more on the expected positive social impacts resulting from the provision of new credit to viable business and households, not only in the initial context section, but also in the options' analysis. As regards territorial impacts, the IA contains useful information at country level (for instance, IA1, pp. 33-34). As regards the environment, the IA does not expect the initiative to have direct environmental impacts.

Out-of-court enforcement tool — The IA provides a matrix contrasting and comparing the key characteristics of the policy options. It analyses the impacts using a structured approach. It first lists advantages and disadvantages of all options. Then, it describes the effects on four main key stakeholders: borrowers, secured creditors, including investors, other creditors, and Member States. Finally, it provides stakeholder views. The methodology used to compare the effectiveness, efficiency and coherence of the options seem to be fit for purpose.

For the Commission's preferred option, the IA goes a step further: it combines in one place an analysis of economic impacts, and elaborates on social impacts, notably by describing the safeguards to business borrowers and the impact on employees. Moreover, it describes impacts on fundamental rights. Finally, it provides a useful table to show impacts on Member States' national legal frameworks (IA2, pp. 65-67), even though its layout could have been improved.

Subsidiarity / proportionality

Both IAs explain subsidiarity issues with arguments echoing the analysis exposed elsewhere. They recall that the problems affect the EU as whole, particularly the Banking Union countries, but also non euro-area Member States (IA1, p. 27; IA2, p. 29). The subsidiary deadline was 11 June 2018 and no national parliaments or chambers raised subsidiarity concerns on the proposal by then.

Secondary markets — The IA explains that a likely reason why Member States have not acted would be 'stigma effects': the reluctance of national legislators to act to transfer NPLs for instance to hedge funds, which have a reputation as 'short-term oriented profit maximising entities', possibly to the detriment of the large social group of debtors. Therefore, the IA recalls the need to 'preserve borrowers' rights' (all the previous quotes are from IA1, p. 28). These stigma effects, at national level but also potentially at EU level, seem to be yet another reason for a more in-depth analysis in the IA of safeguards for borrowers. The IA analyses proportionality: the most proportionate alternative is Option 2 – binding common principles with passport (IA1, p. 55).

Out-of-court enforcement tool — The IA assesses all the options' compliance with the principle of proportionality and selects the most proportionate one as the preferred course of action: the minimum harmonisation of out-of-court collateral enforcement procedures (IA2, pp. 55-56).

Budgetary or public finance implications

The explanatory memorandum of the proposal states that it has no budgetary implications for the EU. The following points relate to public finance implications at national level.

Secondary markets — The IA expects that measures to be selected in this field would lower fiscal costs of banking crises, banking supervision costs and compliance costs. The authorisation of third country firms is expected to be budget neutral, in principle. The IA adds that some Member States that want to maintain their level of debtor protection, where affected by the proposed measures, might need to take complementary policy action (IA1, p. 77). These possible costs are not analysed in depth or quantified.

Out-of-court enforcement tool — The IA expects that the preferred option would increase bank stability and free up court capacity, but would entail some implementation costs (IA2, pp. 43-44). In particular, the one-off costs of the publicity requirements are quantified in the range of €3 000 to €9 000 per public register (IA2, p. 90). Assumptions for this estimate are provided.

SME test / Competitiveness

Both IAs expect that some viable companies that could not get a loan before, should be able to do so once the new measures are in place (IA1, p. 77; IA2, p 61).

Secondary markets — The IA says that the impact on highly indebted SMEs is unknown and will depend on the actual decisions of loan servicers, which may be either stricter or more lenient with debtors (IA1, p. 77). The IA does not analyse at length or quantify potentially lower borrowing costs.

Out-of-court enforcement tool — The IA estimates that the retained option would lower the borrowing costs of companies, including SMEs, by 10 to 18 basis points (0.10 % to 0.18 %), and particularly for smaller companies. The IA provides assumptions for the estimates (IA2, pp. 56-61).

Relations with third countries

Secondary markets — Increasing competition through the entry of foreign firms is one of the stated objectives of the initiative, for both loan servicers and non-performing loans purchasers. The IA argues that both EU and third country companies would benefit from the initiative (IA1, pp. 45-46). However, the IA also says that the top 10 investors in distressed debt are from North America (nine are from the US and one is from Canada) (IA1, p. 114). Therefore, it seems that the IA should have provided a more thorough analysis of the expected balance of benefits between EU and non-EU countries.

Out-of-court enforcement tool — The IA does not elaborate on relations with third countries.

Simplification and other regulatory implications

Secondary markets — The IA analyses in particular the interplay between the development of secondary markets and the other measures of the package.

Out-of-court enforcement tool — The IA analyses also the interplay between the preferred option and, for instance, the Commission proposal on preventive restructuring and second chance.

Quality of data, research and analysis

The quality of the data, sources and knowledge base of the two IAs is quite similar. A comparison of the two list of references, for instance, reveals a similar mix of sources: international institutions, academics, think tanks and interest representatives. Both IAs were prepared by DG FISMA. At least

two meetings of the respective steering groups happened on the same day. However, there are some differences in the way research and analysis is presented and, overall, on quality.

Secondary markets — One strength of the analysis is that the IA is honest about the quality of data and quantification (IA1, p. 109). However, weaknesses include the way the analysis of effectiveness and efficiency is presented, as well as the limited analysis of social impacts. Not choosing a preferred option, while allowed by the Better Regulation Guidelines, when applied to the entire initiative and not only to some of its aspects, as in this case, does result in less accuracy in the impact analysis.

Out-of-court enforcement tool — The IA shows a number of strengths. It broadly complies with the Commission's guidelines, for instance when analysing effectiveness and efficiency, and claims that no exceptions to those guidelines were identified (IA2, p. 70). It tries to analyse some additional elements, such as social impacts and fundamental rights. Finally, the IA states which Commission departments attended the steering group's meetings, and not simply who was invited (IA2, p. 69). This is perhaps a transparent practice that could be mainstreamed.

Stakeholder consultation

The range of consultation activities performed for the two IAs is largely similar. Both IAs are based on the same internet-based [public consultation](#) lasting for at least 12 weeks, as required by Better Regulation Guidelines, and on further meetings with stakeholders and expert groups. However, the level of transparency and detail of information is different, as shown below.

Secondary markets — The IA reports at length on the public consultation and on information from Member States, but does not add detailed information on the meetings with stakeholders.

Out-of-court enforcement tool — The IA provides seven pages of information on the meetings with Member States, expert groups and stakeholders (IA2, pp. 81-87). An additional strong point is the Commission department's stated pro-active approach to reach out to business organisations that did not respond to the public consultation by organising a meeting and reporting on the outcome (IA2, p. 87). The IA provides information on five clusters of stakeholders (IA2, pp 71-80).

Monitoring and evaluation

Both IAs contain monitoring indicators which are in part taken up by the proposal. Both announce an evaluation to be carried out five years after the entry into force of the directive.

Secondary markets — The IA contains a requirement to establish a monitoring programme one year after the legal instrument becomes effective (IA1, p. 60). This seems to be a good practice, but is not taken up in the proposal. The proposal nonetheless provides for an annual evaluation by home Member States regarding the implementation by credit servicers of the safeguards for borrowers (proposed article 21.2). The IA contains at least seven indicators, including a list of authorised credit servicers, which is taken up in the proposed article 8. The IA says that the Commission and national competent authorities will collect the data (IA1, p. 60).

Out-of-court enforcement tool — The IA contains four indicators which broadly seem to correspond to the proposed data collection under article 33 of the proposal. However, the 'evolution of lending to corporates and decrease of cost of lending including cross-border' (IA2, p. 67) is not taken up in the proposal. This indicator might allow one to know in a few years' time if the announced lower lending rates will materialise and whether a correlation or causality can be established.

Commission Regulatory Scrutiny Board

The Commission Regulatory Scrutiny Board analysed draft versions of both IAs on 10 January 2018. It gave a negative opinion on the one on secondary markets and a positive one on the IA on the out-of-court enforcement tool. DG FISMA resubmitted the former IA on 29 January 2018, and it then received a positive opinion. Both IAs seem to have taken into account the [Board's opinion](#).

Nonetheless, the IA on secondary markets still shows some methodological weaknesses, linked in particular to safeguards for debtors, which were 'two newly added [objectives]', according to the Board's opinion. Therefore, a stronger internal process of checking the IA report after the Board's meeting might have been useful.

Coherence between the Commission's legislative proposal and IA

Firstly, the 'political considerations' mentioned in the IA on secondary markets appear to have steered the Commission's choice towards Option 2: Binding common minimum standards with passporting. Secondly, the proposed directive introduces some safeguards for borrowers: for instance, it excludes from its scope loans to consumers and to non-profit making companies, as well as the primary residence of a business borrower. Finally, after a first analysis, the Commission's legislative proposal seems to be coherent with the IA on out-of-court enforcement procedures.

Conclusions

The two IAs accompanying the proposal are similar in the knowledge base underpinning the work and the quality of data and sources. However, there seem to be qualitative differences in the way research, analysis and consultation activities were presented. In this respect, the IA on secondary markets has more room for improvement than the one on the out-of-court enforcement procedure. The latter complies more fully with the Better Regulation Guidelines, for example in terms of analysis of effectiveness and efficiency, quantification, attention to social impacts and impacts on SMEs.

ENDNOTES

¹ See E. Kramer, Minimum loss coverage for non-performing exposures, [initial appraisal](#) of a Commission impact assessment, EPRS, European Parliament, July 2018.

² For further information, see C. Stamegna, Credit servicers, credit purchasers and the recovery of collateral, 'EU Legislation in progress' briefing, EPRS, European Parliament, forthcoming.

This briefing, prepared for the Economic and Monetary Affairs (ECON) committee, analyses whether the principal criteria laid down in the Commission's own Better Regulation Guidelines, as well as additional factors identified by the Parliament in its Impact Assessment Handbook, appear to be met by the IA. It does not attempt to deal with the substance of the proposal.

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