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Proposal for an EU directive on credit servicers, credit purchasers and the recovery of collateral

On 14 March 2018, the European Commission published a comprehensive package of measures to target non-performing loans (***NPLs***) comprising four key areas:

- Ensuring that **banks set aside funds** to cover the risks associated with loans issued in the future that may become non-performing (so-called "**statutory prudential backstop**").
- Encouraging the **development of secondary markets** where banks can sell their NPLs to credit servicers and investors.
- **Facilitating debt recovery**, complementing the EU's proposals for a directive on restructuring and second chance put forward in November 2016.
- Assisting Member States that so wish in the restructuring of banks, by providing non-binding guidance – a blueprint – for establishing Asset Management Companies or other measures dealing with NPLs.

More specifically, the package includes different binding and non-binding initiatives:

- A second progress report on the reduction of NPLs – this is non-binding.
- An amendment to the Capital Requirements Regulation introducing common minimum coverage levels for newly originated loans that become non-performing. This statutory prudential backstop shall address the risk of banks not having sufficient funds to cover losses on future NPLs and prevent their accumulation. It is worth noting that the European Central Bank has on 15 March 2018 published the final version of the addendum to its NPL guidance which addresses the same problem (but with some relevant differences in the approach and temporal scope).
- A proposal for a directive on credit servicers, credit purchasers and the recovery of collateral (the ***Proposals***). This aims to increase the efficiency of debt recovery procedures through the availability of a distinct common accelerated extrajudicial collateral enforcement procedure as well as to encourage the development of secondary markets for NPLs.
- A non-binding technical blueprint for member states on the set up of national Asset Management Companies.

This briefing focuses solely on the third measure outlined above, the Proposals.

What are the Proposals?

The Proposals lay down a common framework for:

- purchasers of credit issued by a credit institution (i.e. non-performing loans);
- provision of credit servicing in respect of non-performing loans; and
- an accelerated extrajudicial collateral enforcement (*AECE*) in respect of secured credit agreements.

The Proposals form part of the EU's Capital Market Union which had as one of its objectives to create the appropriate environment for banks to deal with NPLs. While banks can enforce collateral under national insolvency and debt recovery frameworks, the process can often be slow and unpredictable and deter secondary trading. In the meantime, NPLs remain on banks' balance sheets, preventing banks from focusing on new lending. The Proposals do not apply to purchasing and servicing of a loan carried out by a credit institution in the EU as these are already regulated and supervised.

What are they not?

The Proposals are not (yet) law. They are the Commission's draft of a proposed law. The directive is subject to the co-decision procedure. This means that the Council (i.e. the member states) and the European Parliament will both look at the Proposals and make the amendments they deem necessary. We can therefore expect some dialogue and some changes to this draft before anything becomes final. We understand that the aim is to finalise the process under the current EU mandate – most probably before the next EU election in May 2019.

Once the draft is final and enacted, member states will

have 2 years to implement the measures required, although of course member states will be encouraged to take earlier action.

What is the framework for the purchase of credits?

Member states must ensure that a credit institution provides all necessary information to a credit purchaser to enable the purchaser to assess the value of the credit and the likelihood of the recovery of the value of the loan. To this end, the European Banking Authority is to develop technical standard templates. This seems to suggest that the EBA NPL template that has been developed as a basis for a (voluntary) industry standard may become mandatory for banks selling NPLs.

The Proposals specifically state that member states must ensure that credit purchasers are not subject to any requirements for purchasing credit agreements unless provided by the Proposals. This means that member states may not impose any additional impediments. The purchase of credit agreements should therefore not require a banking license; whether that is also true for, e.g., revolving credit facilities, remains to be seen. Credit purchasers established outside the EU are required to retain an authorised EU credit servicer or an EU credit institution to perform the credit servicing for consumer credits.

The transfer of the credit will need to be notified by the transferring credit institution to competent authorities.

What is the authorisation and supervision of credit servicers?

Credit servicing by anyone other than an EU credit institution is currently an unregulated business in most member states. Under the Proposals, credit servicers (i.e. anyone other than an EU credit institution or its subsidiaries) would now be required to obtain an authorisation before commencing their activities. To this end, member states are to designate a competent authority responsible to supervise credit servicers.

- The Proposals set out certain conditions which must be met in order to obtain such authorisation (e.g. not being subject to insolvency proceedings and having appropriate internal controls for data protection).
- A public register is to be put in place that lists all authorised credit servicers. An authorised credit servicer will be able to provide services across all EU member states if it provides the host member state with certain information ("EU passport").
- Credit servicers must have an appropriate policy ensuring the fair and diligent treatment of the borrowers, and are subject to certain information requirements vis-à-vis borrowers and must establish complaints handling procedures.

What is AECE?

Member states must establish at least one out-of-court enforcement procedure which may be used by secured creditors to enforce security. AECE does not apply to consumer loans (this, we believe, would include residential mortgage loans). Member states must provide for one or more of the following means to realise security: **public auction or private sale**. Where national law provides for appropriation, this may also be used. Member states may provide that a notary, bailiff or other public official is appointed to oversee the process.

- The relevant AECE must be agreed in writing by the creditor and the borrower. This means that AECE is forward looking and primarily intended to prevent excessive *future* build-up of NPLs, rather than deal with already existing loans. We would expect lenders to include AECE in any new loan agreement and/or in any amendments to existing loans once AECE is in place.
- A creditor must notify the borrower of its intention to realise assets through AECE and which type of enforcement process it will be using 4 weeks or such later date as agreed between the parties prior to enforcement.
- Once the borrower has receipt of such notification, it is not permitted to dispose of the assets which are subject to the security and must cooperate with the creditor.
- Member states should ensure that a creditor allows a borrower a reasonable period of time for payment and make reasonable efforts to avoid the use of AECE. There is, as yet, no guidance on what a reasonable time is. If not provided, there is a danger that this may differ from jurisdiction to jurisdiction until there is a ruling by the European Court of Justice.
- Creditors are to organise a valuation of the assets which meets certain conditions (to be conducted by an independent valuer agreed on by the parties, to be fair and realistic and to be conducted specifically for the purposes of realisation of the collateral in AECE). Where parties cannot agree on a valuer the court is to appoint one. In practice, we would expect the valuation process to be dealt with at the outset in the loan agreement. There is as yet no guidance as to the form of valuation models to be used, an area that has in the past, in a number of jurisdictions, been the subject of much litigation.

The Proposals lay down certain elements with which a public auction or private sale would need to comply (e.g. advertisement of the sale, notification of time and place of sale, amount of acceptable reduction in price).

How do the Proposals link in with other EU initiatives?

Where a preventive restructuring framework as introduced by the EU Commission's proposal for a directive on preventive restructuring and second chance (the ***Restructuring Proposals***) is initiated in respect of a borrower,

the realisation of collateral pursuant to AECE will be stayed.

How does this affect the UK?

The timing of the Proposals and then the implementation period means that the Proposals are likely to become law only after the UK has exited the EU. The UK has – unlike some other member states of the EU – a flexible out-of-court mechanism for secured creditors to enforce security, so as regards the UK the Proposals would add a layer of administration not currently present. Conversely, the new regime once implemented in the member states could represent a significant new enforcement right in some member states. Credit servicers registered and established in the UK are unlikely to qualify under the Proposals unless reciprocal passporting arrangements are agreed as part of the Brexit negotiations.

How does this affect Germany?

Apart from certain important exceptions, in the recent past German financial institutions have not been as active in terms of NPL transactions as some other EU member states. However, Germany already has a relatively flexible out-of-court mechanism for secured creditors to enforce security which allows for enforcement via public auction, private sale or appropriation, depending on the relevant type of security. The backlog of NPL deals was in our view less driven by statutory transfer, servicing or enforcement restrictions than by valuation, accounting or tax reasons. Therefore, as far as Germany is concerned, the EU initiative has to date not been seen as a big step – neither in relation to current NPL portfolios nor in relation to future NPL transactions. Similar to the views in the UK, the current view in Germany is that the Proposals are more likely to add a layer of administration and requirements not currently present.

How does this affect Italy?

Italy has been one of the most active jurisdiction in terms of NPL trading in recent years. Yet the purchase of credit is considered to be a reserved activity which requires foreign investors to set up domestic structures. The abolition of domestic barriers in terms of operation of credit purchasers as set out in the Proposals will be a boost to trading.

Italy has recently enacted a reform aimed at facilitating private sales and repossession as an alternative to foreclosure. The Proposals go in the same direction and, in some respects, go further and, if enacted as currently envisaged, will require further amendments to the domestic provisions. How much the AECE will help in Italy remains to be seen as it is not a new build-up of NPLs that is to be tackled but the existence of large amounts of historic NPLs. Lenders may use amendment requests to include AECE into existing loans – but this will be piecemeal.

Access to credit servicers already operating in other member states would be welcomed by the market which is currently characterised by a limited number of independent servicers.

How does this affect Spain?

The Spanish NPL market has been booming in recent years, both in relation to jumbo deals where an institution's entire NPL portfolio has been transferred to a financial sponsor and in relation to specific NPL portfolios. The reasons behind the activity levels include (i) the ability of non-regulated SPVs to become lenders of Spanish clients; (ii) the favourable tax regime; (iii) a reasonably effective enforcement procedure (that includes both judicial and out-of-court enforcement proceedings); and (iv) professional servicers with a successful track record in the management of NPLs and real estate owned.

The impact of the Proposals on the Spanish market remains to be seen. Most of its provisions are already incorporated in the Spanish regulations.

How does this affect Greece?

Similarly to Italy, Greece has recently enacted a number of new laws to facilitate the release of NPLs from its banks and the cleaning up of their balance sheets by establishing a more liquid loan market. As of today, Greece has the largest concentration of NPLs in its banking system of any country within the EU. The new Greek legislation requires transferred loans to be serviced by an approved Loan Management Company licensed by the Bank of Greece. It is easy to see that these could be the pre-cursors of credit servicers under the EU regime.

The implementation of the AECE regime, whilst not assisting with the historic NPL build-up, would bring significant timing and cost benefits to the enforcement process against a debtor under the Greek Code of Civil Procedure (even as recently amended). However, like Italy, for legacy NPLs the Proposals will do little other than possibly providing piecemeal relief.

Where can I find out more?

Click here for our July 2017 briefing "European Union Takes new Steps to Reduce High Level of Non-performing Loans in Europe" and click here for a full copy of the Proposals.

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