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PART 1/2

COMMISSION STAFF WORKING DOCUMENT

IMPACT ASSESSMENT

The development of secondary markets for non-performing loans by removing undue impediments to loan servicing by third parties and the transfer of loans (Part 1/2)

And

Accelerated Extrajudicial Collateral Enforcement (Part 2/2)

Accompanying the document

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 final} - {SWD(2018) 76 final}

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Glossary

Term or acronym	*Meaning or definition*
AECE	Accelerated Extrajudicial Collateral Enforcement
AMC	Asset management company
CEEC	Central and Eastern European Countries
CMU	Capital Markets Union
distressed debt	Debt securities, bank debt, trade claims or other financial securities (CDS, options, etc.) of companies under financial stress
EBA	European Banking Authority
EBITDA	Earnings before interest, taxes, depreciation, and amortisation
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
ESRB	European Systemic Risk Board
EUR	Euro
FED	Federal Reserve Board (US central bank)
GDPR	General Data Protection Regulation
HQ	headquarter
IMF	International Monetary Fund
loan loss provisioning	amount expense set aside as an allowance for a loan becoming non-performing
loan servicer	firm specialised in the administration of a loan to ensure the collection of debt
MS	Member State, Member States
NBER	National Bureau of Economic Research
NPL	Non-performing loan. Bank loans past due 90 days without the borrower paying the agreed instalments or interest
SMEs	Small and medium-sized enterprises
SPV	Special Purpose Vehicle: structure used to securitise assets
SSM	Single Supervisory Mechanism

1. INTRODUCTION: POLITICAL AND LEGAL CONTEXT

1.1. The need to address Non-performing Loans in the EU

Following the financial crisis, the regulatory framework for banks has changed substantially. The European Union has taken the lead in implementing reforms agreed globally at the level of the G20 and in the Basel Committee with the objective of reducing risk in the banking sector, reinforcing financial stability and avoiding that taxpayers have to contribute financially to the costs of failing banks. In addition to these measures, the institutional arrangements for the supervision and resolution of banks in the EU have been strengthened fundamentally with the establishment of the first two pillars of the Banking Union (BU): the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM).[1] As a result of these measures, the EU banking sector is in a much better shape today than in previous years.

Nevertheless, several challenges remain to be addressed, including how to decisively address the high stocks of non-performing loans (NPLs) and other non-performing exposures (NPEs)[2]. NPLs have piled up in parts of the EU banking sector in the aftermath of the financial and sovereign crises and ensuing recessions. High levels of NPLs in parts of the banking sector pose significant risks to financial stability and the overall economy in the EU, unlike in other major economies such as the United States or Japan which have previously taken a number of actions to reduce the level of NPLs and repair banks' balance sheets.[3]

High NPL ratios[4] can weigh on a bank's short- and longer-term performance through two main channels. First, NPLs generate less income than performing loans – thus reducing bank profitability – and may cause losses that diminish the bank's capital. In the most severe cases, these effects can put in question the viability of a bank with potential implications for financial stability. Second, NPLs tie up significant amounts of a bank's resources, both human and financial.[5] Banks saddled with high levels of NPEs have therefore only a limited capacity to provide new credit to viable businesses. Small and medium-sized enterprises (SMEs) are particularly affected by the reduced credit supply, as they rely on bank lending to a much greater extent than larger companies, thereby affecting economic growth and job creation.[6]

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1 The third pillar of the Banking Union, the European Deposit Insurance Scheme (EDIS), was proposed by the Commission in November 2015.

2 NPEs include non-performing loans (NPLs), non-performing debt securities and nonperforming off-balance-sheet items. NPLs, which term is well established and commonly used in the policy discussion, represent the largest share of NPEs. Throughout this document the term NPL is meant in a broad sense equivalent to NPE, and hence the two terms are used interchangeably.

3 See, for example, FSC (2017) "Report of the FSC Subgroup on Non-Performing Loans"; FSI (2017) "Resolution of non-performing loans – policy options"; and IMF (2015) "Global Financial Stability Report, Chapter 1: Enhancing policy traction and reducing risks".

4 The term NPL ratio refers to the ratio of non-performing loans to total outstanding loans.

5 A large portion of the employees' time is spent dealing with lengthy procedures required to manage NPLs. As NPLs are considered riskier than performing loans, they may require higher amounts of regulatory capital if left un-provisioned.

6 Simulations by the IMF (2015b) suggest that a reduction of European Non Performing Loans to the historical average ratio (by selling them at net book value i.e. after provisioning) could increase bank capital by EUR 54 billion. This would under some assumptions enable EUR 553 billion in new lending.

For all these reasons, the Commission has for a long time highlighted the urgency of taking the necessary measures to address the risks related to NPLs.

While tackling NPLs is primarily the responsibility of national authorities[7], there is also a clear EU dimension of the NPLs issue. Given the high level of economic and financial integration in the EU, and especially within the euro area (EA), there are important potential spill-over effects from Member States with high levels of NPLs to the economies of other Member States and the EU at large, both in terms of economic growth and financial stability.[8] Weak growth in some Member States due to elevated NPL levels might affect economic growth elsewhere. Also, weak balance sheets of just a few banks can negatively affect investors' general perception of the value and soundness of other EU banks. This can unnecessarily raise the funding costs for the sector as a whole, which may adversely affect the cost of credit to borrowers.

Addressing high stocks of NPLs and their possible future accumulation is therefore essential for restoring the competitiveness of the banking sector, preserving financial stability and supporting lending to create jobs and growth. This analysis is shared by a number of reports from European institutions, international organisations, and think tanks.[9]

1.2 Recent evolution of NPLs

The general improvement in NPL ratios over recent years continued in 2017, as did the quality of banks' loans portfolios. The latest figures confirm the downward trend of the NPL ratio, which declined to 4.6% (Q2 2017), down by roughly 1 percentage point (pp) year-on-year (see Figure 1). This reduction was mainly the result of one-off events that impacted all bank-size classes, in particular smaller banks. However, the ratio remains elevated when compared to historical norms and to other regions[10] and the total volume of NPLs across the EU is still at the level of EUR 950 billion.[11]

The situation differs significantly across Member States (see Figure 2). Several countries still have high NPL ratios (9 had ratios above 10% in the second quarter of 2017), while others have rather low ratios (10 Member States were below 3%).

There is evidence of some progress in reducing NPL ratios in the most affected countries, owing to a combination of policy actions and a stronger macroeconomic environment. However, significant risks to economic growth and financial stability remain and progress is still slow, especially where it is needed the most. Structural impediments continue to hamper a faster fall in NPL stocks. Provisioning is often still too slow and insufficient to allow for effectively resolving and preventing any critical accumulation of NPLs in the future. Among other elements, activity on secondary markets for NPLs is also not yet sufficient to

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7 As also underlined in the European Semester recommendations to relevant Member States.

8 See ESRB (2017) and IMF (2015).

9 See ECB (2016, 2017), EBA (2017), FSC (2017), ESRB (2017), IMF (2015a, b), Vienna Initiative (2012), Baudino and Yun (2017), Bruegel (2017), Barba Navaretti et al. (2017).

10 The NPL ratio for both the United States and Japan was around 1.5 % in December 2016.

11 Source: ECB.

substantially contribute to NPL reduction efforts, notwithstanding the increased interest from certain investor groups and the increasing volume of NPL-related transactions.

Figure 1 EU Non-Performing Loans ratio

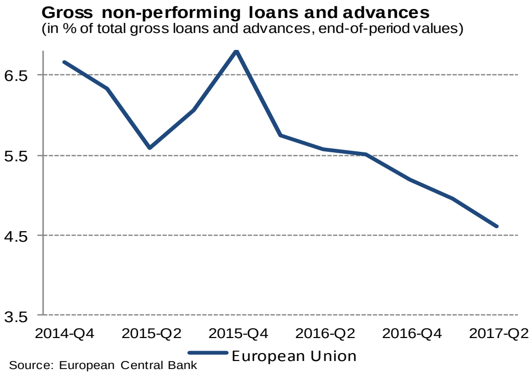
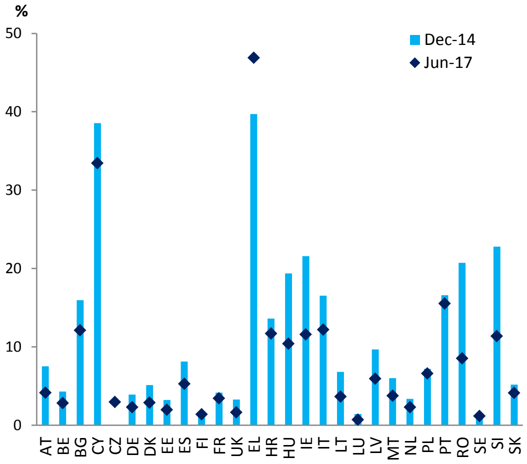


Figure 2: NPL ratio in EU Member States



Source: ECB. Note: Dec-2014 not available for CZ.

1.3 Towards a comprehensive package of measures to address NPLs

A comprehensive and credible strategy to address NPLs is an essential and urgent step towards restoring the viability of – and hence investor confidence in – the EU banking sector. Pursuing a comprehensive strategy and taking determined action to address NPLs is also essential for the smooth functioning of the Banking Union and the Capital Markets Union (CMU) and for a stable and integrated financial system. In this way, the resilience of the Economic and Monetary Union to adverse shocks will be enhanced by facilitating private risk-sharing across borders, while at the same time reducing the need for public risk-sharing.

Integrating national and EU-level efforts is needed to address the NPL problem, both on the existing NPL stocks and on future NPL flows. Reflecting the EU dimension and building on previous work by the Commission and other competent EU authorities, the Council adopted in July 2017 an Action Plan To Tackle Non-Performing Loans in Europe.[12] It recognises that work in this area must be based on a comprehensive approach combining a mix of complementary policy actions, since the complexity of the problem simply does not lend itself to a single *'silver bullet'* solution.

The Council Action Plan combines various measures by national governments, bank supervisors and EU institutions that improve the tools and incentives for banks to pro-actively address NPLs either by internal work-out or through disposal. In practice, this means enhancing legal frameworks relevant for both the prevention and resolution of NPLs, including the functioning of secondary markets. However, other measures such as improving

[12] See http://www.consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans/

the availability and quality of data on NPLs or improving the market infrastructure (eg. set-up of trading or information platforms) are equally important. If the right pre-conditions are present, tools such as Asset Management Companies are also an efficient way to allow resolution of NPLs while removing NPLs from the banking system in the short term.

The Commission has committed to delivering on the parts of the NPL Action Plan within its remit. Accordingly, the Commission announced in its October 2017 Communication on completing Banking Union a comprehensive package for tackling high NPL ratios, to be put forward by Spring 2018.[13]

This "Spring package" consists of the following measures:

- A Blueprint for how national Asset Management Companies (AMCs) can be set up in compliance with existing EU banking and State aid rules by building on best practices learned from past experiences in Member States.
- A legislative initiative to further develop secondary markets for NPLs, especially with the aim of removing undue impediments to loan servicing by third parties and to the transfer of loans to third parties.
- A legislative initiative to enhance the protection of secured creditors by allowing them more efficient methods of value recovery from secured loans through Accelerated Extrajudicial Collateral Enforcement (AECE). This refers to an expedited and efficient out-of-court enforcement mechanism which enables secured creditors (banks) in all Member States to recover value from collateral granted by companies and entrepreneurs to secure loans.[14]
- A legislative initiative amending the Capital Requirement Regulation (CRR), with regard to the introduction of minimum coverage requirements for incurred and expected losses on future NPLs arising from newly originated loans, in order to backstop potential under-provisioning of future NPLs and prevent their build-up on banks' balance sheets.
- A way forward to foster the transparency on NPLs in Europe by improving the data availability and comparability as regards NPLs, and potentially supporting the development by market participants of NPL information platforms or credit registers.[15]

13 COM(2017) 592 final, 11.10.2017, available at: http://ec.europa.eu/finance/docs/law/171011-communication-banking-union_en.pdf.

14 This initiative will remain consistent with and complementary to the Commission proposal of November 2016 for a Directive on, inter alia, preventive restructuring frameworks and would not require harmonisation of actual insolvency provisions.

15 In addition, the Commission is also undertaking a benchmarking exercise of loan enforcement regimes to establish a reliable picture of the delays and value-recovery banks experience when faced with borrowers' defaults, and invites close cooperation from Member States and supervisors to develop a sound and significant benchmarking methodology. In this context, the 2016 Commission proposal for a Directive on business insolvency, restructuring and second chance lays down obligations on Member States to collect comparable data on insolvency and restructuring proceedings.

The Council Action plan initiatives under the responsibility of other EU institutions and competent authorities include, among others:

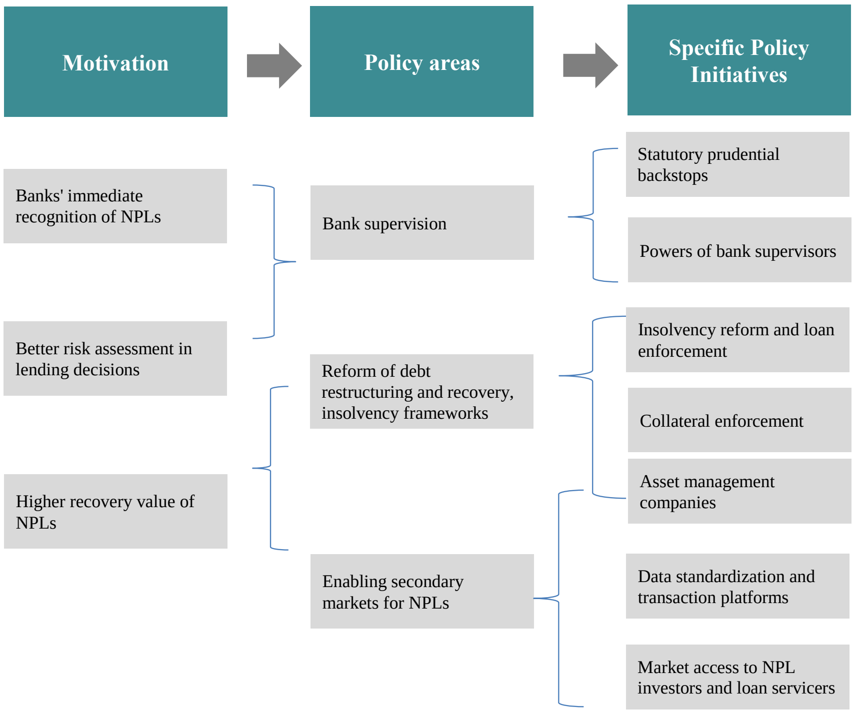
- General guidelines on NPL management applicable to all EU banks;
- Detailed guidelines on banks' loan origination, monitoring and internal governance, addressing in particular transparency and borrower affordability assessment;
- Macro-prudential approaches to prevent the emergence of system-wide NPL problems, taking into account potential pro-cyclicality and financial stability implications of NPL policy measures;
- Enhanced disclosure requirements on banks' asset quality and non-performing loans.

1.4 Commonalities and interdependencies of the various measures

The legislative and non-legislative initiatives of the Council Action plan are interlinked and mutually reinforcing. They should create the appropriate environment for dealing with NPLs on banks' balance sheets. Some of them have an impact on the reduction of the current stock of NPLs, and all are relevant for reducing risks of future NPL accumulation. Their impact is expected to be different across Member States and affected institutions. Some will have a stronger impact on banks' ex ante risk assessment at loan origination, some will foster swift recognition and better management of NPLs, and others will enhance the market value of such NPLs.

The Commission's three legislative initiatives, namely i) statutory prudential backstops for loan loss coverage; ii) the development of secondary markets for NPLs, and iii) accelerated extrajudicial collateral enforcement mechanisms, mutually reinforce each other and also interact with the other measures of the Council Action Plan. For example, the prudential backstops initiative ensures that credit losses on future NPLs are sufficiently covered, making their resolution and/or disposal easier. These effects would be complemented by better developed secondary markets for NPLs as these would make demand for NPLs more competitive and raise their market value. Furthermore, accelerated collateral enforcement as a swift mechanism for recovery of collateral value would reduce the costs for resolving NPLs. These interactions are described in greater detail in the below box.

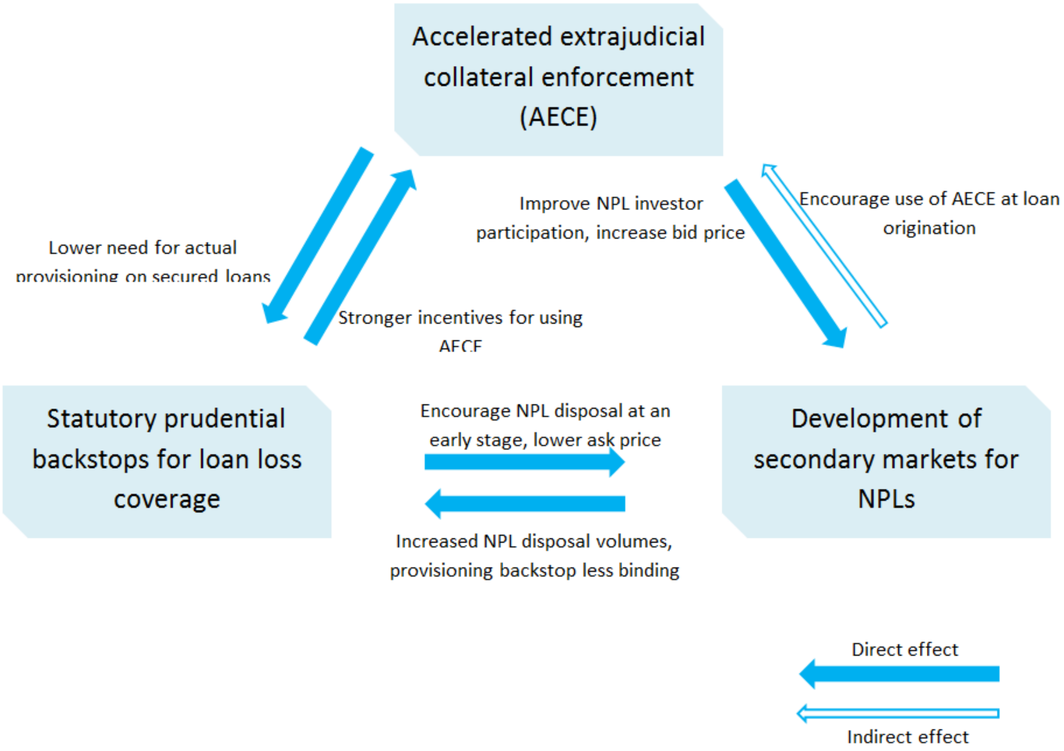
Figure 3 Commission's policy initiatives within the NPL Action Plan



Box on the reinforcement effects between the Commission's legislative initiatives

This box assesses the possible reinforcement effects between the three initiatives of the Spring package, namely i) statutory prudential backstops for loan loss coverage; ii) development of secondary markets for NPLs, and iii) accelerated extrajudicial collateral enforcement mechanisms. As is the usual practice, each individual impact assessment gauges the incremental effects of the proposed measure against a no policy change baseline. The underlying idea of the NPL package is, however, that the effects of each initiative will be mutually enhancing. The exact quantification of these feedback effects is a quite complex exercise as it is subject to strong modelling uncertainty. This box hence provides a qualitative description of the feedback channels and their relative strength.

Figure 4 - The reinforcement effects between the initiatives of the NPL package



Effects of Accelerated extrajudicial collateral enforcement (AECE) on other initiatives

As AECE becomes more popular and used by credit institutions, the *statutory prudential backstop* measures would be less binding. Indeed, banks would tend to restructure, recover or dispose of their NPLs earlier and at a higher rate. They would be less affected by the need to increase provisioning as time goes by, as required by the prudential backstops measures.

Given that the AECE feature would follow the NPLs following their disposal to a third party, this would help the *development of the secondary market* by increasing investor participation and thereby its liquidity (NPL demand-side effects). In particular, shorter time of resolution and increased recovery, as expected with AECE, would increase the bid prices. Moreover, the harmonization achieved by AECE would foster development of pan-European NPL investors, further improving market liquidity.

Effects of Statutory prudential backstops on other initiatives

The more costly in terms of higher provisioning it becomes for banks to keep secured corporate NPLs on their balance sheets due to the new prudential backstop rules, the higher the incentives for banks to restructure, recover or dispose of NPLs quicker and earlier, and hence the higher the *use of AECE* directly (by triggering it) or indirectly (by disposing of the NPL to a third party).

Holding NPLs on the balance sheet will become costly over time, providing an incentive for banks to dispose of NPLs on *the secondary markets* at an early stage, when the backstops require less minimum coverage. Once the minimum coverage level required by the backstops becomes more binding, the carrying book value of NPLs will be reduced. Both of these mechanisms would ensure more sellers participation on the secondary market (NPL supply-side effect), thereby reducing the ask price of NPLs.

Effects of the development of secondary markets for NPLs on other initiatives

Improved investor participation and better functioning of secondary markets would reduce the bid-ask spread and increase the volume of NPLs that are transferred to third parties. Banks would dispose of NPLs more eagerly and at an earlier stage, therefore the *provisioning backstop* would be less often binding.

With a more liquid and better functioning secondary market for NPLs where investors show appetite for NPLs with the AECE feature, there would be additional incentives for credit institutions to *use AECE* at origination of new loans. This indirect feedback effect would become active once sellers realise that it is easier to dispose of NPLs having the AECE feature to third party investors.

The effectiveness of the three aforementioned legislative measures would increase if banks are adequately capitalised in the future. Better capitalised banks will be more eager to sell NPLs in the secondary market or to realise the collateral of a non-performing loan in a timely fashion. Furthermore, statutory minimum coverage requirements would provide strong incentives for banks' management to prevent the accumulation of future NPLs through better NPL management and stronger loan origination practices. This will reinforce the expected effects of the EBA's and ECB's work on banks' loan origination, NPL management, monitoring and internal governance practices. Work on NPL information and market infrastructure would further enhance the functioning of NPLs secondary markets. Lastly, measures related to loan enforcement would complement the Commission's November 2016 proposal for a Directive on business insolvency, preventive restructuring and second chance, by increasing the chances that viable businesses survive while non-viable activities are swiftly resolved.[16]

1.5 The scope of the impact assessment

The initiative to develop secondary markets for NPLs discussed in this text focuses on a specific issue that is not taken up in any of the other policy measures in the Action Plan, namely to remove impediments to transfers of NPLs from banks to other entities and to simplify and harmonise requirements for loan servicers. Being one of the four key areas in the Action Plan, stakeholders signalled the importance of secondary markets for the resolution of NPLs in the public consultation that preceded this impact assessment (see Annex 2) as did banks contributing to the EBA Risk Assessment Questionnaire. In the latter, they considered the lack of secondary markets for NPLs one of the two most important impediments to the resolution of NPLs.[17]

The initiative analysed here is unique among all measures following the Council Action Plan as it is the only legislative measure that targets an increase in demand and to raise competitive pressure on the demand side of the NPL market. Most other measures in the NPL Action Plan will also have an impact on NPL secondary markets. The introduction of prudential backstops would increase banks' incentive to sell NPLs. The establishment of AMCs has been historically one of the driving forces kick-starting secondary markets of NPLs, bringing in

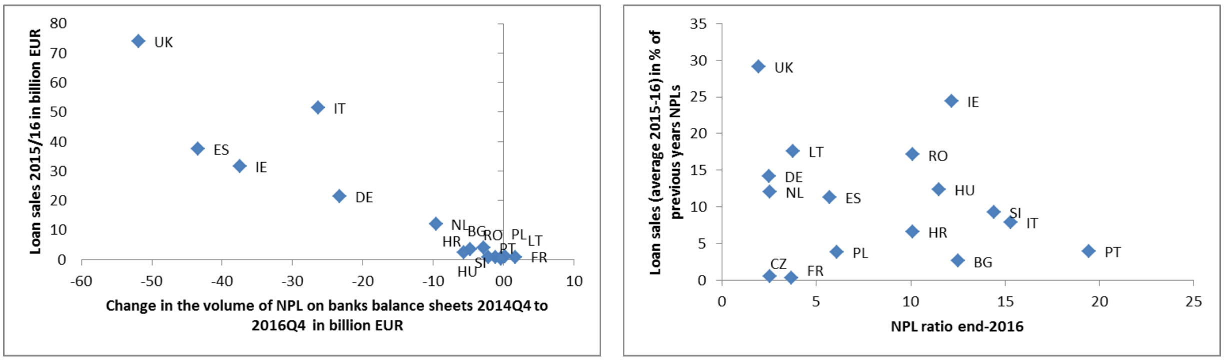
[16] COM(2016) 723 final.

[17] In EBA's September 2017 questionnaire, banks indicated both the lack of a market for transactions in NPLs and the length and costs of judiciary process as the most important impediment (agreement of about 55%, Question 26 for banks).

economies of scale, advantages of specialisation and improved pool valuation.[18] Functioning AMCs can thereby help to both expand and to smooth the supply side of the NPL market. Data standardisation and transaction platforms improve the matching process of demand for and supply of NPLs. Measures to improve insolvency and enforcement would increase the recovery value of NPL, increasing the value for both demand and supply side. Annex 4.1 describes how the different initiatives set up in the Council Action Plan should impact on prices and traded volumes by depicting a stylised view on demand and supply conditions on the secondary market for NPLs.

Figure 5: Loan transactions and NPLs across selected EU Member States

a: Volumes in billion EUR **b: in % of loans and NPLs**



Source : COM calculations with data from EBA and various consultancies (see Annex 4.2).

Since most other measures of the NPL Action Plan will also have an impact on the secondary market for NPL loans, the ultimate impact of this work stream depends also on the success of the other measures in the NPL Action Plan. At the same time, the effectiveness of other policies is questioned without a functioning secondary market for NPLs. Especially the benefits of AMC and supervisory action could become fruitless if demand for NPLs is missing.

2. PROBLEM DEFINITION

The consequence of missing or underdeveloped secondary markets for NPLs is that banks with high NPLs have limited scope to sell them to non-banks or only at high transaction costs leading to low prices. This holds in particular for smaller banks, which may have high NPL ratios and a strong incentive to sell, but find that search and transaction costs are over-proportionally high for smaller portfolios.[19] The prospect of low prices on loan sales means banks may realise losses, which erodes their capital base and therefore represents a disincentive to sell.[20]

If NPLs cannot to be disposed, they stay on banks' balance sheets and require provisioning, which reduces banks' profitability and business opportunities. NPLs also generate uncertainty about asset quality, which decreases investors' demand and increases banks' capital costs. The overall result of both effects is reduced credit supply and higher lending rates, which tend to

18 See IMF (2015a).
19 See ESRB (2017).
20 See FSC (2017).

disproportionately affect lending to SMEs.[21] High NPLs bind bank operating resources and potentially prevent banks from carrying out more productive uses.[22] This effect is particularly material in smaller banks having less specialised staff. Moreover, the difficulty to assess the value of a bank which has a large stock of NPL on its balance sheet holds back merger and acquisition activity in the EU banking sector, often described as oversized.[23] Finally, a higher stock of NPLs on banks' balance sheets as consequence of a lack of secondary markets for NPL would mean that banks' are more exposed to financial turmoil, i.e. the risk of financial instability is higher.

2.1 What is the problem?

Despite some momentum in recent years, secondary markets for non-performing loans hardly exist in Europe. According to the SSM, euro-area Member States do not have a developed NPL market except Spain and Ireland, whose state of development is characterised as medium.[24] Also outside the euro area, markets are small and underdeveloped in most EU Member States except in the UK. While a genuine single market for NPLs in the EU would be difficult to realise in view of considerable cross-country differences in other relevant areas, in particular insolvency law, investors have been looking for opportunities beyond borders, i.e. some of those active first in the UK and Ireland and then in Spain, have entered the market in Italy or several CEECs.

Markets tend to be characterised by comparatively small trade volumes, a few large transactions involving a limited number of active investors, large bid-ask spreads when counterparts enter negotiations and a lack of transparency on market prices.[25] At the same time, Member States with higher loan sales recorded a stronger decline in their banks' NPL ratios (see Figure 10 and Figure 11), suggesting that secondary markets for NPL are contributing importantly to reduce NPL ratios.

Apart from data of NPLs on banks’ balance sheets recorded by banking supervisors and central banks, which represent the potential supply of NPL, there are no official statistics to track NPL markets. Banks are not obliged to reveal them to statistical offices and often have no incentive to disclose details. Some consultancies collect data of individual sales from various sources and publish their information in reports. This data is used in this Impact Assessment. Information about realised market prices is generally not available, but treated as confidential by the parties involved in the transaction. See Annex 4.2 for a discussion of data availability and quality and Box 1 in Annex 5.1 for a review of issues with the data on loan sale volumes.

[21] See IMF (2015) and the references to empirical papers quoted therein. See also ESRB (2017).

[22] ESRB (2017) argues that bankers have a comparative advantage in borrower relations and customer service, but not necessarily with respect to NPL resolution. Private equity and asset management firms can specialise in the operational and/or financial restructuring of viable borrowers and the maximisation of collateral value collection.

[23] For a review of the channels through which NPLs impair merger and acquisitions activity, see the special feature in the ECB (2017b).

[24] See SSM (2017), Table 13.

[25] See FSC (2017), Chapters 4.2.3 and 8. See also Bruegel (2017).

Major consultancies point to less than EUR 120 billion of transactions in debt sales in 2016 in the EU, which corresponds to estimated EUR 100 billion NPLs sold.[26] The market overview in Annex 5.1 documents that the secondary NPL market is concentrated in the EU, with a strong clustering in four countries (ES, IE, IT and the UK) and dominance of large buyers (23% market share of the top five buyers, largely US or UK domiciled, over the last 2½ years).[27] According to market sources, prices depend strongly on the characteristics of the underlying loans, varying from 5-10% of face value for unsecured consumer loans to 50-60% for secured (mortgage) loans.[28] Annex 5.1 reviews the existing data on market structures.

This apparent malfunctioning of the market is driven by problems of incentives for engaging in transactions and sufficient information about possible transactions that banks as sellers of NPLs and non-banks as potential buyers face. Information problem occur on both sides because the value of an NPL is difficult to establish given its dependence on the likelihood and amount borrowers will pay back, the value of any underlying collateral and the time and effectiveness of legal or out-of-court enforcement.[29] They lead to high transaction costs. This is visible in a high gap between prices offered and bid for NPLs, entailing disincentives for banks to sell as well as limited participation of potential investors. NPLs are not an established asset class investment funds traditionally focus on, implying that precedent their involvement they need to set up a new strategic orientation and investment mandates. A particular factor that can discourage NPL investors to enter the market is the difficulty to access third-party loan servicers. Loan servicers have been virtually absent in most EU Member States until recently. Their activity is segmented by country due to local regulations, which prevents them from realising scale economies.

Incentive problems give rise to market failures leading to high transaction costs

On both market sides, there are underlying incentive problems that lead to a wide bid-ask spread.[30] Buyers assume, and therefore discount, the sellers' incentive to overrate the quality of the product.[31] Buyers have less information about the quality of the asset than the sellers. Exposure to such information disadvantage about the quality of the asset will be reflected in a risk premium that reduces the bid price of the prospective buyer. At the same time, the selling banks anticipate that the potential acquirer assumes that the bank is under pressure to divest the NPL portfolio. Otherwise it would keep it on its balance sheet and take the losses. In this

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26 Loan sales are measured in gross book value of the loans, usually equal to the unpaid primary balance that the debtor owes to the creditor. EU transactions in 2016 were 118 billion in PWC Portfolio Advisory Group (Market update 2016Q4), EUR 108 billion in Deloitte (2017), EUR 110.5 billion by KPMG European transactions dashboard. The share of NPLs in loan sales is estimated at about 70-80%. See Annex 5.1

27 See Bruegel (2017).

28 See AFME (2017), quoting PWC data.

29 Potential buyers may anticipate that if banks have an opportunity to sell loans, they have a reduce incentives to adequately screen (prior to credit origination) and monitor (after credit origination) their borrowers.

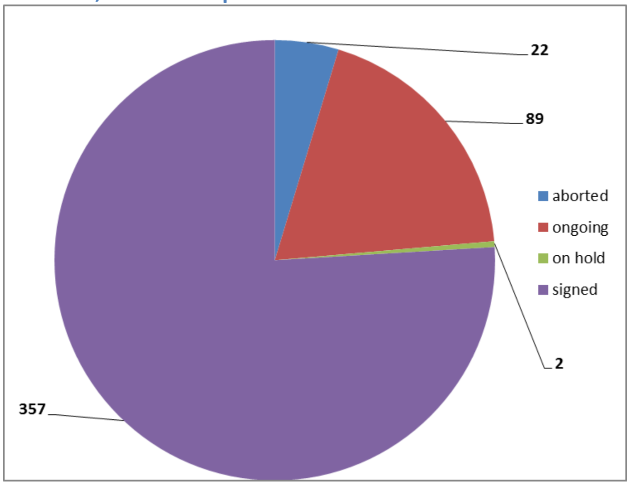
30 A high bid-ask spread was frequently mentioned in the public consultation and is a prominent feature in the literature. See for example FSC (2017), ESRB (2017) and Bruegel (2017). EY (2017) estimated the bid-ask gap to be 20% for secured Italian NPLs.

31 For an application of the lemon problem on NPL, see ECB (2016) and ESRB (2017).

strategic setting, banks have an interest to demand a higher price than justified by the true value of the NPL portfolio whereas investors have an incentive to understate their preparedness to pay.[32]

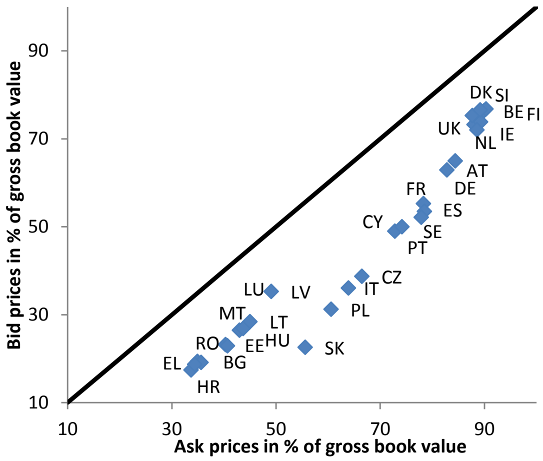
Negotiation about the purchase of an NPL entails significant transaction costs to agree on a price and other contractual terms, in addition to the information costs the buyer has to carry to evaluate the NPL portfolio. The difficulty in closing the gap between bid and offered prices and arriving on an agreed price between supplier and buyer leads to a long negotiation period and often prevents that deals are concluded. The available data reported in Figure 6 reveals that about a quarter of the loan sales transactions initiated in 2015 and 2016 were still not concluded in September 2017.

Figure 6: Number of loan sales transactions recorded in 2015 and 2016, Status in September 2017



Source: COM calculations with KPMG data, which is retrieved from publicly available sources.

Figure 7: Bid and ask prices for NPLs across EU Member State derived by a theoretical model



Source: Commission calculations (see Annex 4.3). Note: The diagonal line represents a situation where the theoretical bid and ask prices are equal. The higher the vertical difference between the data points and the diagonal line, the higher is the estimated bid-ask gap.

Since market participants do not disclose actual bid and ask prices, the gap between them can only be estimated by means of a theoretical model that combines the main determinants of price formation on both market sides. Figure 7 shows how initial bid and ask prices could differ across EU Member States using the model presented in Annex 5.3 The difference from the bold 45 degree line indicates the size of the bid-ask spread.

Additional factors that influence bid and ask prices are listed in Box 2 in Annex 5.1. The other measures in the NPL Action Plan, such as the establishment of transaction platforms or data standardisation, would reduce transaction costs and therewith the bid-ask gap and thereby foster demand for NPLs. They would not address the mentioned distorted incentives, which

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32 The use of an advanced auction technique (Vickery method, i.e. the portfolio is awarded to bidder with the highest price, but at the second highest price offered) by Fannie Mae and Freddie Mac in their auctions of NPLs can be considered evidence that the suppliers of NPL suppose that potential buyers are misrepresenting their valuations when they bid for NPLs.

lead to reluctance of banks to sell. Establishment of AMCs could also reduce transaction costs and the bid ask spread, for example through re-packaging of NPL portfolios from different banks. They could also be instrumental in re-balancing bargaining power on NPL markets, thereby addressing the incentive issue. Market structure would then be determined by few large players with market power on both demand and supply side of the market. While this may lead to higher NPL prices and lower bid-ask gap, it may also discourage market entry of further, especially smaller, investors and therewith not engineer an increase in demand for NPLs.

Limited buyers' participation and weak competition leading to lower bid prices and concentration on large NPL portfolios

Low demand for NPLs has led to small transaction volumes and low bid prices.[33] Market entry of new non-bank investors could enlarge the investor base and thereby increase demand and competitive pressure. Higher competition among NPL buyers, in turn, would increase bid prices, entailing larger incentives for banks to sell. Entry conditions for potential NPL investors are therefore a critical parameter to stimulate demand.

New entrants could come from various sources. There are third-country investment funds that target distressed debt or special situations, but not yet active in Europe. There are also smaller NPL investors in European Member States that target their home market, but refrain from acquiring loans in other Member States. Finally, there are also a few European firms that acquire NPL portfolios from various European banks, but specialise on specific asset classes (see Annex 5.1). Institutional investors such as pension funds and insurance companies are usually not active as direct market participants, but according to market sources some hold shares in investment funds that buy NPLs.[34] Taking a standard market diagram, an increase in the investor base would translate into higher bid prices and higher demand (see Annex 5.1). Policy measures that stimulate banks to supply NPLs or improve matching process are subject to other NPL work strands in the Action Plan (see Annex 4.1).

Foreign firms have been the largest investors in NPLs. Among the largest 10 investors in global distressed debt are 9 domiciled in the US and one in Canada (see Table A.5.1 in Annex 5.1). Broadening the potential investor base would be essential to increase demand for European NPLs. Since smaller European banks have a large exposure to NPLs, there seems to be also a mismatch in the size of NPL portfolios between what smaller banks could sell and non-bank investors currently active in the markets are interested to buy. While there are some smaller to medium-sized European investors in the market, they seem so far to be specialised on specific asset classes or Member States, and realise somewhat smaller average transaction volumes.[35]

[33] Bruegel (2017) lists the concentrated NPL investor base as a market failure.

[34] One respondent to the public consultation argued that the direct participation of institutional investors would require NPL portfolios to become available in form of securitised products.

[35] See Annex 5.2 for an overview of major firms active on the buyer side of the market.

Limited availability and limited geographical reach of loan servicers

A particular factor that can discourage NPL investors to enter the market is the difficulty to access third-party loan servicers. Many submissions to the public consultation supports the notion that access to loan servicers is important for NPL markets to develop.[36] Member States with high NPL volumes and relatively vivid loan sales such as IE, IT and ES have on average more loan servicers whereas in some other Member States such as FR and AT, loan sales are under-proportional and loan servicers play little role (see Annex 5.2).

Loan servicers take care of the "after-sale services", they administer the interest payments of debtors, collect the principal, send notices and conduct other activities that affect the recovery value of NPLs. They have a particular role in the administration of NPL portfolios once these are sold, because it is important for the buyer of an NPL portfolio to exclude the originating bank from the debt collection to take full ownership and resolve any possible moral hazard.[37] See Box 1 in Annex 5.2 for a review of the value added of loan servicers.

Most buyers of NPLs are investment funds or asset managers without loan servicing capacity. Their expertise is in asset valuation and risk taking. They require access to third-party loan servicers for managing NPLs. Since loan servicers request a fee for doing so,[38] high costs for loan servicing are a potentially important deterrent for non-bank investors to acquire NPLs.

Facilitating the expansion of loan servicers across borders would allow them to tap scale economies, compete for business and provide their services to NPL investors at lower prices. Loan servicers have been virtually absent in most EU Member States until recently.[39] Despite dynamic adjustment in the sector in the last two years, activity has remained fragmented along national lines.[40] Loan servicers are segmented by country, due to local regulations, and by asset class. It is known from the US market that loan servicing benefits from scale effects, which implies that small loan servicers are less efficient.[41] Though based on a small number of observations and subject to a number of methodological caveats, Figure 8 suggests that third-country loan servicers active in the EU are on average larger and more profitable.

36 See reply to question 16 in Annex 2.

37 See Box 2 for an account of the advantages and disadvantages of employing independent loan servicing companies.

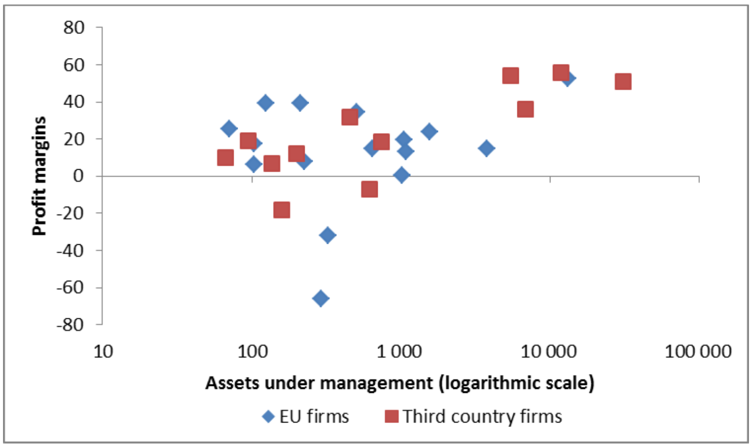
38 About 0.5-1.5% per annum of the exposure managed according to market sources. See Annex 5.2.

39 Annex 5.2 gives an overview of activity and market structures.

40 This notion is strongly supported by the replies to the public consultation (see Annex 2).

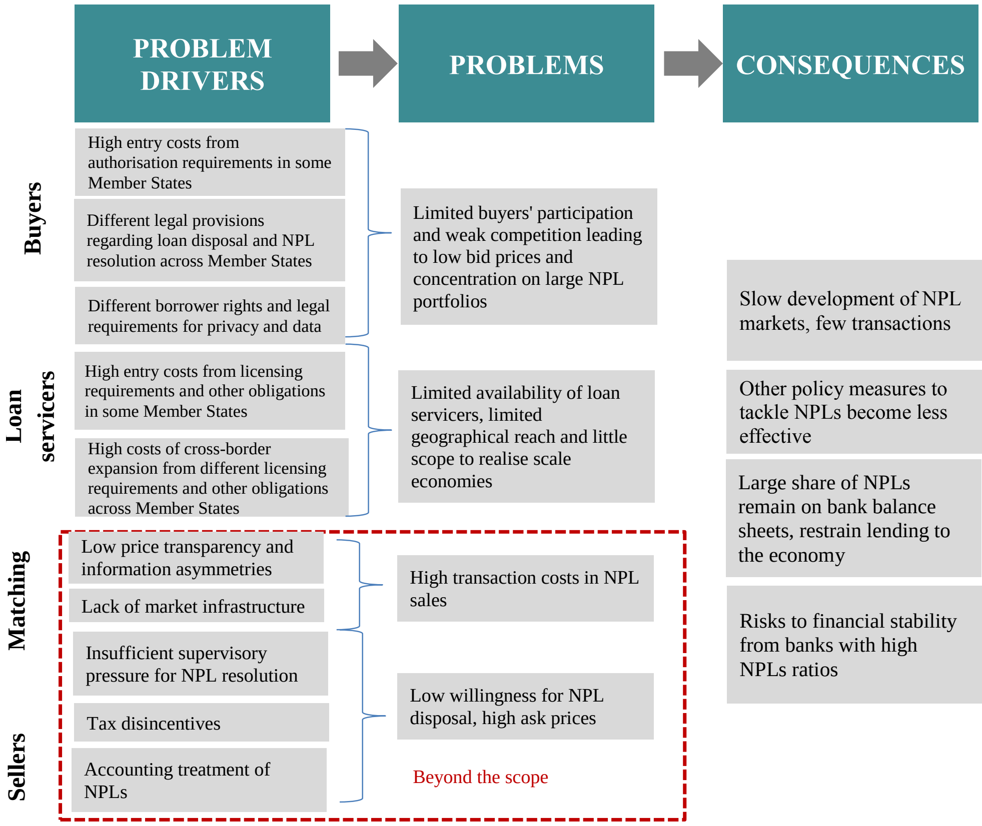
41 See Federal Reserve Board et al. (2016) and Annex 5.2.

Figure 8: Size and profitability of firms offering loan servicing in the EU



Source: Commission calculations with individual firm data derived from Orbis or company accounts. See Annex 5.2.

Figure 9: Problem Tree



2.2 What are the problem drivers?

The public consultation and a questionnaire sent to EU Member States about rules pertaining to NPL investors and loan servicers in their jurisdiction helped identify factors that discourage participation and limit incentives to conduct cross-border activity (see Annexes 2 and 6).

High entry costs from authorisation requirements for loan purchases in some Member States

Entry conditions are a critical parameter to augment the investor base for NPLs, to increase competitive pressure and thereby kick-start market development.[42] In several Member States, non-banks are required to have authorisation from a public body if they purchase loans from banks. Especially where a full banking license (as opposed to other more specific licensing requirements) and a physical presence in the Member State concerned are required this represent costly entry barriers for potential NPL buyers in some Member States.[43] Motivation for authorisation requirements in some cases is based on debtor or data protection concerns, in others on a definition of bank activity that includes factoring services, or links holding of a loan portfolio to credit creation. Significant compliance costs seem also due if the NPL purchase requires the establishment of a securitisation vehicle or investment firm.[44] Other costly barriers relate to registration in each Member State they want to be active in, administrative delays and limitations on the loans they are allowed to acquire.[45] Non-EU institutions face the same requirements as EU-domiciled investors in most, but not all, Member States. [46] (see Annex 6).

Table 1: Entry conditions for NPL investors

Banking license or authorisation from central bank or supervisor	BG, EL, CY, HU, LT*, MT, AT, PT*, SI, SK+,
Authorisation from other institution	DK, RO
Different authorisation for performing and NPL	BG, FR, LT, PT, RO, SK
Need to employ authorised loan servicers or specific structure (SPV, AIF)	DE, IE, EL, IT, PL, SI+,UK
Investment in NPL constrained for some types of investment funds	BE, BG, ES, HU, FI

* for performing household loans, ** for performing loans, + for consumer credit

For more details, see Annex 6 and Appendix 6.A.3

Entry costs differ depending on firm characteristics and Member State (see Annex 3.2 and the Box in the Annex). Market sources describe them as not insurmountable, though scarcity of data and large variation in the few observations made available to Commission services do not allow an in-depth assessment. Costs to obtain authorisation are estimated to be below EUR 100,000 in most cases, unless a banking license or a securitisation vehicle is required. For example, if a NPL investor can perform under the regulatory regime of an investment

42 ESRB (2017) confirms the importance of entry costs and time and suggests activity around these lines would be rewarding.

43 In some Member States only entities holding banking licenses are allowed to buy NPLs, including CY, SI (for consumer loans), and DE (where further loan drawings may be involved). In others, like ES (for mortgage loans) and HU, only financial entities are allowed to buy NPLs. In RO, investors have to be authorized by the domestic Consumer Protection Authority and in DK, they need to be licensed debt collectors. In IT, investors are able to invest in NPL portfolios only through a local SPV supervised by the national authority.

44 Examples flagged in the public consultation refer to alternative investment fund management structures in PL, securitisation vehicles in IT.

45 The time required to obtain a license varies from 1 month to maximum 12 months, according to Member States information (Annex 6.1).

46 In Germany, non-EU investors investing in NPL are required to establish a local German servicing enterprise.

fund, the regulatory start-up costs would range between about EUR 10,000 to about EUR 15,000.[47]

In addition to the actual compliance costs in monetary terms, authorisation and licencing procedures entail additional economic costs because they require potential market entrants to acquire legal expertise to understand and fulfil obligations.[48] Taking the investment fund industry as a benchmark, a recent Commission study suggests that direct regulatory fees could amount to less than 20% of the regulatory start-up costs, about 40% of the regulatory start-up costs might be attributable to compliance costs in terms of labour costs and another approximate 40% to pay external servicers for local facilities in the host country. [49] Market sources interviewed by the Commission assessed the average of total costs to enter a new NPL market at about EUR 60,000 to 100,000. Hence, compliance costs are deemed not particularly high in relation with total entry costs incurred by investment firms.

Different legal provisions regarding loan disposal and NPL resolution across Member States

A further obstacle to market entry stems from the legal differences and the uncertainty this creates for the loan acquirer about their rights with respect to loan enforcement from the ultimate debtor.[50] See Table 1 for an overview of specific provisions in EU Member States. The European Commission’s survey revealed that while all Member States allow the transfer of a loan, the legal instrument is different as it either entails the transfer of the credit rights or the transfer of the loan contract. Hence, entry and conduct rules for investors willing to buy NPLs differ across EU Member States and in some Member States by type of loan, implying that investors' interest to buy and therewith banks' ability to sell NPLs is fragmented across Member States and also by asset class.[51]

Differences in the legal framework entail additional costs for investors active on different national markets. They mean potential foreign NPL non-bank investors need to identify and respect the relevant licensing requirements and compliance costs in each Member State they want to be active in. Moreover, loan acquirers need to adapt their business model to each legal framework, which implies that for each Member State where they want to buy NPLs they have to develop an idiosyncratic approach for the valuation of loans, their relationship with the debtor, the procedures to enforce loans and other parts of their business conduct.

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47 European Commission (2017), Impact Assessment: Initiative cross-border distribution of investment funds.

48 See Annex 3.2 for an overview of costs and their determinants.

49 European Commission (2017), Impact Assessment: Initiative cross-border distribution of investment funds.

50 This includes inter alia access to collateral, out-of-court enforcement and court rulings.

51 For example, only financial institutions are eligible creditors to floating mortgages and financial collateral in ES. Licensing of third parties for loan purchase is necessary for selling NPL consumer loans SI while for the sale of NPL corporate loans, there are information restrictions.

Table 2: Different requirements to business activity of NPL investors across EU Member States

Debtors consent required, OPUC	BE, SI*, SK,
No transfer of consumer credit loans, OPUC	BG
Restrictions on transfer of collateral, OPUC	CY, UK
Mandatory notification required	BG, CZ*, DE*, EE, EL, IE*, HR, CY, HU, PT, SK, FI
Specific loan form for transfer of the loan or the collateral	LV, LT, HU*, SI
Notarial certification and registration general practice or required for the transfer of some assets	BE, BG, CZ, DK, DE, IE, ES, FR, AT, PT, SI
Specific requirements for some loans	BE, DE, AT, SI, SK, ,
Transferor requires authorisation from supervisory authority	BE, DK*,HR, LV, LT*, HU*, AT*
Banks retain responsibility if loan is transferred to entities not subject to bank secrecy	CZ, LT, MT, SK
Banks are not totally discharged from data protection responsibility	EE, PT, SI
Transfer of confidential data restricted, OPUC	BG, AT

* for specific loans or cases
OPUC := overriding possible under conditions

Source: Member State information, see Annex 6.1.

The costs for NPL investors that the fragmentation of legal frameworks across Member States entails could be a reason why about 75% of the investors that bought NPL portfolios in 2015 and 2016 did so in only one Member State (see Table in Annex 5.1). The replies to the public consultations reveal that stakeholders consider the legal framework, insolvency rules and local habits as obstacles for cross-border activity. Some respondents also referred to data issues or incentive problems as factors (see Annex 2).

A cost estimate of the impact of these factors is not possible given the lack of data and strong differences across Member States. Information from market sources suggests that costs for supervisory reporting, internal audit, risk compliance, credit management procedures and anti-money laundering differ substantially across firms. A common pattern is that costs for compliance with anti-money laundering legislation are sizeable, which is in line with the prominence of know-your-customers concerns in the replies to the public consultation.

High entry costs from licensing requirements and other obligations for loan servicers in some Member States

Loan servicers are exposed to challenges similar to NPL investors with respect to authorisation and licensing. Regulatory entry barriers are more widespread across Member States than those for NPL investors and often motivated by debtor and data protection considerations. For this reason, some Member States even request physical presence in the Member State. The request for authorisation and domiciliation in particularly allows supervision by domestic authorities. Since restructuring of a loan can entail new lending, some Member States request from loan servicers to obtain a banking license.[52] Some Member States also insist that NPL investors make use of loan servicers that are licensed and supervised by their authorities (See Annex 6)[53]. Non-EU loan servicers are permitted in all Member States, except one.[54]

Table 3: Entry conditions for loan servicers

Banking license	DE*, FR**, HU, MT**, AT, RO**, SK
Authorisation from central bank or supervisor	EL, IE, NL*, PT, UK
Authorisation from other institution	DK, SE, FI, IT, LV, LU
Restrictions on debt enforcement	BG, DK

* depends on decision of supervisor, ** if activity covers lending or refinancing.
For more details, see Annex 6 and Appendix 6.A.3.

While fees for obtaining a license vary across Member States, they are overall small compared to overall entry costs loan servicers face, estimated to amount to EUR 5-15 million.[55] From the limited information the Commission services were able to obtain, one-off fees for the licensing range from a few hundred to more than EUR 50,000. Annual licencing fees vary significantly as well, ranging from a few hundred euro per annum to more than EUR 30,000. Compliance costs for data reporting could add to these set-up and licencing fees as well as the costs to comply with anti-money laundering rules that may prove significant.

High costs of cross-border expansion from different licensing requirements and other obligations for loan servicers across Member States

Cross border expansion can help loan servicers to grow and realise scale effects, thereby allowing them to offer lower prices for NPL investors. Since this requires multiple authorisation processes and adjustment of the business models to national conditions, cross border expansion is made more costly by differences in licensing and conduct rules across Member States. Loan servicing activities primarily fall under the freedom of contract, and there are no formal legal definitions of 'servicing', 'managing' and/or 'debt collection' of loans in most Member States. The resulting legal uncertainty about definitions applied in other Member States could be a reason why few loan servicers pursue cross-border expansion strategies. Reduction of legal uncertainty by the adoption of legislation that governs the establishment of loan servicing firms, as part of the country's economic adjustment programmes, has been instrumental in fostering the market in Ireland. Comparable legislation

52 In almost all Member States, servicers do need to comply with certain fit-and-proper requirements. In IE and EL, servicers are required to comply with specific requirements and only entities that have an appropriate licence can conduct credit servicing. In LV, a provider of debt recovery services requires a special license. In DE, FR, HU and AT, they require a restricted banking license.

53 For example, NPL investors can acquire loans in EL only under the condition that they have signed a loan management agreement with a servicing company properly licensed and supervised by the Bank of Greece. In DE, non-EU investors investing in NPL are required to establish a local German servicing enterprise.

54 In EL, non-EU loan servicers are not permitted and non-Greek EU loan servicers must act through a branch. In AT, in case of pure outsourcing, stricter requirements can apply especially with regard to data protection issues.

55 ESRB (2017) quotes market information for this estimate.

has also been adopted in Greece and has led to the establishment of loan servicing firms in that country very recently.[56]

A specific point to loan servicers is how their relationship with non-bank NPL investors is governed, which entails possible restrictions on which services they are allowed to offer to the latter. There are no explicit prerequisites that a creditor has to satisfy before outsourcing certain servicing functions unless outsourcing is deemed to affect core functions or services in almost all Member States. However, loan monitoring and refinancing, which are typical by-products of loan servicing are considered a core services in some Member States.[57] In this case, outsourcing to loan servicers is not allowed or tied to strict requirements. Moreover, the creditor cannot outsource the undertaking formal enforcement actions in the large majority of Member States, i.e. investor-linked servicers are not permitted to undertake such actions on the creditor's behalf.

The variation in licensing costs across Member States referred to above can serve as an approximation of the entry burden to loan servicing markets. In the absence of direct cost estimates, evidence that they have a material impact can be derived from the observation that as regards cross-border entry or expansion of loan servicers, the most frequent approach in the last years has been the acquisition of existing national loan servicers, implying that expansion to a new market is difficult without national incumbents already being present.

Different borrower rights and legal requirements for privacy and data

Respondents to the public consultation stress data and information problems to be a major obstacle to the acquisition of NPLs. Restrictions on non-bank investors are motivated by concerns about bank secrecy and personal data protection. These restrictions impair the transfer of information from the bank to the non-bank investor. This, in turn, complicates the evaluation of the value of the loan portfolio before the sale is signed, i.e. the potential buyer has only access to limited and anonymised information from which he needs to assess the recovery value of the NPL and, to the extent loans are collateralised, the value of the underlying collateral. The existing fragmentation among Member States of rules on data protection renders data management by non-bank investors more difficult in case they aim administer loans from different jurisdictions at a central place in order to realise scale effects.[58]

Bank secrecy provisions generally contain an exemption that allows the bank to disclose data which are necessary and proportionate for selling the loan. The FISMA survey unveiled legal constraints in a number of Member States. For example, the transfer of confidential data is only allowed under the debtor's consent or an authority's decision in a few Member States (see Annex 6). Despite possible constraints from privacy and personal data protection, banks as sellers and non-banks and buyers have found ways to cope with them, for example by

[56] A first loan servicing firm was authorised in July 2017.
[57] See Annex 6.
[58] This situation is expected to improve with the application of the General Data Protection Regulation as from May 2018 and the harmonization of data protection rules resulting therefrom.

providing anonymized or aggregated data in the pre-transaction phase. Hence, rather than making it impossible to negotiate a trade of NPLs, they increase transaction costs.

Cross-border transactions could entail conflict of laws. For example if an NPL purchasers from a different Member State than the originating bank and the borrower sells the loan on to a further NPL purchaser in another country. The latter may then question which national law applies, especially if the NPL purchaser is in a third country. For cross-border transactions in the EU, the so-called Brussels I and Rome I rules apply. In case of a third country and of a borrower that is a consumer, the consumer law and jurisdiction should, in principle, also apply but the situation would need to be assessed on a case by case basis taking also into account the third country rules on conflict of laws. Therefore, parties to a cross-border transfer of loans have to do their due diligence based on a set of potentially applicable laws. This inflates the costs of legal opinions required for due diligence[59].

Borrower rights, in particular consumer rights, are different across Member States and also defined via different legal means, e.g. through insolvency regimes, borrower and consumer protection laws, or authorisation and supervision procedures. These rights do not change with the transfer of a loan from a bank to a third party.[60] However, the legal protection of borrowers' rights might be affected if the transfer of the loan modified the contractual relationship, if it led to a change of applicable law to a different country's law, or if it became subject to a different regime of general rules on debtors' protection. This could be problematic, in particular, for debts referred to consumers. Both NPL investors and loan servicers therefore need to adjust their business models to the legal regime in each Member State they want to be active in. Table 2 lists a number of rules that NPL investors and loan servicers have to adhere to in the different Member States. The existence of various country-specific legal requirements implies that a single market for NPLs in the EU will still remain segmented along national lines even if authorisation and conduct rules for NPL investors and loan servicers are standardised.

Differences in borrower rights across the Single Market motivate authorisation processes for NPL investors and loan servicers in some Member States. For example, IE and EL explicitly request compliance with borrower protection rules in their laws that authorise loan servicers, SE mandates the authorisation process to the data protection authority. Other Member States may not explicitly require a license out of the motivation to safeguard borrower rights or personal data protection. Registration and licensing, nevertheless, gives them an opportunity to monitor and/or supervise behaviour of the firm, therewith act if compliance with national law is jeopardised.

Are the problem drivers significant?

Policy makers have control over regulatory costs, such as direct costs of obtaining an authorisation to do business, and indirect costs that emerge from rules that govern the conduct

59 The Commission undertook a public consultation on the conflict of laws rules for third party effects of transactions in securities and claims in 2017.

60 For example, recital 41 of the Consumer Credit Directive 2008/48 states: "assignment should not have the effect of placing the consumer in a less favourable position.

of business and may limit profit opportunities. While the rules in place determine costs of compliance for market entrants, not all entry costs can be influenced through policy measures. An important fixed-cost component in the entry decision of the NPL investor is the due diligence that has to be performed on any NPL portfolio targeted. Moreover, potential entrants need to invest in studying local legal conditions that determine the recover value of the loans as well as the legal rights and obligations they would have as loan owners.

The replies to the public consultation suggest that a large share of the respondents considers an EU framework helpful and that licensing rules should be part of it (see Annex 2). While market sources indicated that regulatory costs are not their main concern when deciding to enter NPL and loan servicing markets, this suggests that regulatory costs are not an insignificant part of entry costs.

Even if these regulatory costs may not be high in absolute terms, their impact on entry decisions is amplified by:

- expanding the disadvantage vis-à-vis incumbent market players that already benefit from an information advantage from past experiences. Entry decisions are surrounded by uncertainty and complex interactions among a multitude of relevant factors. Most importantly, entry costs have the character of sunk costs, i.e. they are foregone and not reversible if the plan to enter the market is aborted or the activity turns out not to be sufficiently profitable. Since it is uncertain that a deal with a bank can be closed, the sunk cost character of entry investments has a significant impact on the decision to enter NPL markets.

- becoming recurring for each national market that the investor wants to enter or expand to. Regulatory costs and different national rules undermine the possibility of NPL investors to enter smaller markets and of loan servicers to realise scale effects. They especially increase search costs if either of the two considers expanding activity to another Member State. The different legal rules across EU Member States may also discourage particularly foreign investors to enter EU markets, for example US investment funds that are used to face uniform rules and try to realise scale economies from conducting large transactions. For example, scale economies are well documented for US loan servicers.[61]

- translating into search costs required to find out what regulatory requirements and related costs actually are, which again increases with each national market the investor wants to enter. The latter two are particularly important for foreign investors. In the NPL market, entry costs entail search costs, compliance costs, costs for advise on legal and administrative matters. Investors active in the NPL market report that costs to understand local conditions and the relevant legislation matter importantly.

Other problem drivers

It should also be noted that the public consultation revealed a number of further factors, which stakeholders consider important to foster activity on NPL and loan servicing markets, and

[61] See Federal Reserve Board et al. (2016) and Annex 5.2.

which are not addressed here. Stakeholders also often stressed the impact of harmonised insolvency frameworks and improved debt enforcement as relevant for the development of secondary markets. Access to data is also an important factor for potential buyers in order to assess the value of an NPL portfolio. Market sources often refer to a lack of supply of NPLs from banks. These are subject of other work strands of the Action Plan, addressing specifically, a review of national insolvency frameworks, templates for standardised data through which banks facilitate buyers' evaluation of loan portfolios and means to establish a transaction platform. Taxation was also repeatedly listed. An obvious point is that banks are exempted from VAT while loan servicers are liable to VAT. Annex 6.2 summarises obstacles to the development of secondary markets for NPLs flagged in the public consultation, including those that are subject to other work strands of the NPL Action Plan.

2.3 How will the problem evolve?

Without supportive policy measures, one could expect that the investor base in NPL grows along its past trend and that loan sales may not increase by much as compared to the level of EUR 100 to 150 billion per annum as realised in the last years. Loan sales may even decline as past activity was concentrated in a few countries, and in some of them the stock of NPL has already declined (e.g. UK, DE) whereas loan sales in some Member States with high NPL ratios would remain at the modest level realised in the past. The consequence would be that revenues from NPLs sales remain modest and the NPL stock on banks' balance sheet declines gradually.

One could assume a decline in the NPL ratio along the GDP growth path. Credit growth has been sluggish in countries with high NPL ratios. This could continue and may feed back into relatively weaker economic growth in these countries.[62] If national markets become attractive (for example through supervisory pressure on banks to sell NPLs or reform of insolvency law that increase recovery values) market demand could develop endogenously and when faced with high opportunity costs of non-action, Member States may adopt legislation to support this process. The cases of Ireland and Greece suggest that even if the NPL problem is recognised by policy makers as requiring action, it takes time until for example laws that govern market entry into loan servicing markets are in place.

3. WHY SHOULD THE EU ACT?

3.1 Legal basis

Article 114 of the Treaty on the Functioning of the European Union (TFEU) confers to the European institutions the competence to lay down appropriate provisions that have as their objective the establishment and functioning of the single market. NPL purchases are a form of capital movement under the free movement of capital principle, which is applicable to investors from third-countries like the US as well. The problem that the initiative under consideration aims to address is related to different rules in the Member States as regards the rules for third parties acquiring NPLs from banks, as well as rules for offering loan servicing

[62] A recent research paper estimates that NPLs would decline significantly in Italy only if economic growth was higher than 1.2% per annum. See Mohhaddes et al (2017).

services (see Annexes 6 and 7) that restrict both the free flow of NPLs within the EU and investment opportunities for third-country investors. Consequently, the development of a single market for NPL investors and for loan servicers faces obstacles and without measures at EU level, national markets for NPLs and loan servicers will remain fragmented and in most Member States underdeveloped.

3.2 Subsidiarity: Necessity of EU action

The analytical work leading to the NPL Action Plan demonstrated that NPL ratios are currently high in a substantial number of Member States, reaching unsustainable levels in a few cases.[63] This legacy stock of bad debt creates risks of cross-border spill-overs throughout the EU economy and its financial system. Moreover, the high stock of NPLs alters market perceptions of the European banking sector as a whole and represents negative externalities for the whole EU.[64] These factors have become even more relevant in the context of the Banking Union. By contributing to enhanced growth and reducing financial fragmentation, measures to address the existing stock of NPLs would be beneficial for the EU as a whole.[65]

With respect to building up or expanding the investor base for NPLs, Member States have an incentive to act and reduce regulatory barriers to attract foreign investors and to facilitate domestic investors or loan servicers to enter the market. A few Member States have actively acted to address the high stock of NPLs (IE, ES, EL, PT, SI), in most cases fostered through an EU/IMF economic adjustment programme.[66] Yet, progress in these Member States remains slow and did not counteract the spill-overs of risk perceptions of a weakened EU banking system as a whole. Given the inability to address the issue through action at the level of individual Member States, the subsidiarity principle warrants action at EU level.

While policy measures at the national level are possible, they are likely to cement market fragmentation. IE and EL set up legislation that governs the licensing process of loan servicers. Both, however, followed different approaches: the Irish law requests compliance with light fit-and-proper criteria for the authorisation without inference on business conduct, whereas the Greek law is more demanding, requesting for example loan servicers to act through a local entity and to take care of socially vulnerable groups (see Annex 66).

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63 See FSC (2017), ESRB (2017), ECB (2016, 2017).

64 This was for example evident in a decline of share prices of almost all EU banks larger than the decline in the general stock price index when EBA released stress test results in summer 2016, although the results showed large differences among participating banks and suggested little exposure to stress for a considerable number of banks. For empirical analyses on spill over in the European banking system, see European Commission (2017a) and the references therein.

65 From the ECOFIN Action Plan: "The Council […] RECOGNISES that although in the majority of Member States high NPL ratios did not emerge in recent years, the negative effects of current high NPL ratios in a substantial number of Member States can pose risks of cross-border spill-overs in terms of the overall economy and financial system of the EU and alter market perceptions of the European banking sector as a whole, especially within the Banking Union."

66 Progress has become visible in rising transactions in NPLs with non banks once an asset management company was set up (IE, ES, SI) to collect NPLs from banks and make them available for sale. In Italy, acute banking problems gave rise to public support measures that incentivised the sales of NPLs to non-banks.

Stigma effects are a very likely reason why Member States have not yet taken a more active stance in reducing regulatory barriers to attract foreign investors to the NPL market. While there is no hard evidence on such factors, a number of channels may be relevant. Ultimate debtors represent a larger social group than creditors and they may see little advantage from a transfer of the ownership of their debt to foreign investors. They may even experience uncertainty if their debt is transferred from a creditor they know to an unknown third party entity and if they encounter difficulties to clarify whether or not the rules protecting them would remain valid. Since foreign hedge funds are the most visible NPL investors, their reputation as short-term oriented profit maximising entities may discourage policy makers from taking action to facilitate their operations. Legislators also strive to keep consumer protection at high levels and may fear that the transfer of NPLs to non-banks could challenge this protection. This initiative aims at addressing impediments to loan transfers, while ensuring that borrower rights in Member States are preserved.

3.3 Subsidiarity: Added value of EU action

An EU-wide framework for NPL buyers and loan servicers would help reap scale effects and reduce entry costs for firms intending to operate in different national markets. It would help overcome the coordination issue in EU NPL markets where weaknesses in demand and supply amplify each other. In particular, banks would benefit from a larger investor base since competition among investors would exert upward pressure on prices. Investors, in turn, would benefit from a unified European legal framework as it would reduce their entry costs and create more favourable conditions and infrastructure for their cross-border operations.

Under an EU framework for loan servicers, firms' activity would be less constrained by the size of the domestic market. Consequently, expansion to other markets would allow loan servicing companies to grow in size and to realise scale effects, and potentially charge lower fees to NPL investors. Moreover, NPL purchasers would no longer be required to build a new relationship with a loan servicer in each market, but they would be able to work with a loan servicer they worked with in other Member States.

So far, debt servicers and investors concentrate on a handful of national markets, probably those with highest profit margins. In order to reap opportunities in other markets, they need to acquire expertise about prevailing local regulation and about the availability of loan servicing firms. While these search and compliance costs may not be very high, they still represent an effective obstacle to entry if the target market is small.

Developing an EU-wide investor base for NPLs would also be key for the effectiveness of other measures in the NPL Action Plan since the efficiency of asset management companies in coordinating NPL supply, of bank supervision in earmarking NPLs, information templates to standardise information on NPLs depends on the potential demand for NPLs.

Measures at EU level would also be beneficial to overcome the stigma effects that Member States face when pursuing legislative changes at national level in this area.[67] However, these

[67] Ireland and Greece, which stand out as Member States that initiated legislation on loan servicers, did so as part of programme conditionality.

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.

4. OBJECTIVES: WHAT IS TO BE ACHIEVED?

A first general objective of the NPL package is to 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. A second general objective of NPL reduction is the support of stable financing to the economy and therewith economic growth. Banks saddled with NPLs tend to face higher funding costs and capital requirements and lower profitability, which limits their ability to extend new credit. Persistently weak loan portfolios are thus a potential drag on financing of firms, households and ultimately economic growth. Functioning secondary markets for NPL would allow banks to sell NPLs to non-banks, thereby reducing risks of financial stability and liberate resources to expand lending to the economy.

The first specific objective of this initiative is to stimulate demand for NPLs by generating a larger investor basis, and consequently also greater competition among investors. Greater demand for NPLs and greater competition among investors is expected to contribute to both a higher volume of NPL transactions and higher bid prices on secondary markets. This should contribute to reducing NPLs in banks’ balance sheets, thereby enhancing banks' resilience, and ultimately improving lending to the economy as well as reducing risks to financial stability. While the immediate objective is to decrease the presently high level of NPLs in the EU and some of its Member States in particular, a larger participation of buyers on NPL markets will also be beneficial in case of future accumulation of NPLs on banks' balance sheets.

Mirroring an increase in buyers' participation on NPL markets, a second specific objective consists in a complementary increase in the capacity of loan servicing firms to absorb rising demand for their servicers from more loan sales by NPL investors. Demand would be most efficiently matched if prices for loan servicing are competitive and geographical reach expands to all Member States.

More specifically, to strengthen the demand side and competition on these markets, the initiative aims at: (i) facilitating market entry of NPL investors and loan servicers in MS with high NPLs and material obstacles to market entry, (ii) fostering the entry of smaller firms so that smaller banks have a higher chance of finding counterparts in NPL transactions, (iii) equal treatment across markets in Member States, allowing loan servicers to realise scale economies from cross-border operation, (iv) enhancing competition through the entry of foreign firms. The first two items could be considered as means to address failure in (national) NPL markets, whereas the latter three may be instrumental in fostering a single NPL market.

The investor base would be largest if a single market was created, so that investors would not discriminate across conditions on various national markets, and if conditions would be supportive to foreign firms' market entry. The objective of a genuine single market seems very ambitious given the importance of national and local determinants on NPL markets. Still it would be desirable that both domestic and foreign investors can expand activity across borders as easily as possible, so as to come close to a shared investor base among all EU Member States. Harmonised licensing and conduct rules could deliver this. The same could be accomplished by converging rules at national level. This would result in increased transactions of NPLs, eventually leading to a reduction of NPLs in banks.

More competition on loan servicing markets should result in lower costs charged by loan servicers to NPL holders and create profit opportunities through lower administrative costs and/or allowing synergy effects with other business areas. Creating wider profit margins through lower administrative costs and/or allowing synergy effects with other business areas should also lead to higher preparedness to pay for NPL investors, implying a pass through to prices that banks can realise when they offer their NPL portfolio.

Changes to entry conditions for loan purchasers and loan servicers could change the relationship between borrower and creditor and their negotiation position, especially since the transfer of the loan entails that the borrower faces a new counterpart that she/he had not chosen and possibly not even known. If this new counterpart is located or authorised in a different Member State, the borrower may consider these rights undermined, even if the contractual obligations of the new creditor remain unchanged. It is therefore also an objective of the initiative (v) to ensure efficient supervision and (vi) adequate safeguards for borrower rights. This would require, in particular, that the borrower protection clauses of the original contract are fully maintained even in case the contractual terms are modified as a result of the transfer the loan and that the general set of consumer protection rules in force in the country of the debtor is fully maintained and adequately enforced even in the case the debt servicer operates in regime of passport.

It would be problematic if purchasers of NPL were outside the scope of existing data protection rules. Acquisition of NPL by non-EU funds will imply either a transmission of data (if the acquirer processes the data in the EU) or a transfer of data (if he processes them in a third country) from the banks to the acquirer. In both cases the rules of the General Data Protection Regulation (GDPR) apply with particular reference to rules on international transfers in the latter case. Since GDPR provides maximum harmonisation, Member States cannot raise protection standards. Since the GDPR contains a number of "opening clauses" which allow Member States to further specify its rules and since there might be differences between Member States' approaches to its implementation, there is a potential for downgrading of the actual protection data receives if the new data controller is in a different country. Such a downgrade would be avoided if the acquirer of the credit had to respect the personal data protection prevailing in the country of the borrower.

5. WHAT ARE THE AVAILABLE POLICY OPTIONS?

5.1 Framing the policy options' features

Entry and business conditions for both potential NPL buyers and loan servicers currently vary across Member States, as described in Section 2.2 and in Annex 6. This situation can be improved through various channels, such as simplifying and reducing cross-country variation of authorisation and licensing procedures and reducing administrative barriers and cross-country variation in information sharing rules, etc. This section defines a set of dimensions with available alternative policy choices. This framing of policy features will subsequently be used to define the policy options.

Authorisation procedures for loan purchasers

The entry conditions for loan investors often take the form of an authorisation procedure by National Competent Authorities (NCAs). One of the main divergences among Member States is whether or not a banking licence is required for loan purchasers. A lighter authorisation procedure would rely only on fit-and proper criteria (e.g., good repute of directors, to consider capital requirements or professional insurance, organisational requirements on IT, risk control, internal audit, compliance office). The authorisation requirement for purchasers can be partially or fully waived in cases where the loan purchase is registered with a NCA and the loan is serviced by an authorised servicer. Different setups are possible as regards cross-border activity of loan purchasers (national authorisation, passporting, single authorisation, etc.).

Business rules for loan purchasers

Rules applicable to the activity of loan investors may stipulate whether some types of transfers are restricted or require additional authorisations. As regards the resolution of NPLs, restrictions may apply for loan purchasers with respect to rescheduling of the original loans (in some Member States a banking licence is required). Member States have different legal instruments to transfer loans and a number of civil law provisions that may impose constraints on what NPL purchasers can undertake, for example if debtors are in insolvency procedures. Making these subject to harmonisation appears not proportional and is therefore not considered part of the option set.

Scope of eligible loans

The set of loans non-banks are allowed to buy differ among Member States. While a few do not have any limitations, some, e.g. BG, FR, LT, PT, RO, SK have different rules for non-performing and performing loans. The purchase of consumer credit loans is not possible in BG while also BE, LT, NL, SI and SK have special protection for household loans or consumer credit. While the main public interest is in enabling the purchase of non-performing loans, it is difficult to control in practice because most loans are sold in large portfolios. Some of these portfolios contain both performing and non-performing loans.

While their interest in maintaining a customer relationship with performing borrowers creates an incentive for banks to limit purchases to non-performing loans, actual sales often include sales that do not fall under the formal definition of non-performing. This includes: Some loans are expected to become non-performing, others may be partly performing, some may be performing, but from debtors that did not service other loans, etc. Part of the wider market for loan sales are also loans supplied by public asset management companies as consequence of the wind up of credit institutions. [68] The actual share of non-performing loans in loan sales is unknown; the estimations shown in Annex 4.2 suggest it could be between 70 and 80%. The counterpart of about a third of NPLs on banks' balance sheet are households and the share of loan sales owed by consumers was at least 11% in 2015-16.[69]

68 For example, one of the largest sales in 2017 related to a portfolio by UK asset manager UKAR and compromised a face value of 11.8 billion GBP in 104000 performing loans that originated from Bradford and Bingley before the banks was taken in public ownership in 2010. See http://www.ukar.co.uk/media-centre/press-releases/2017/31-03-2017?page=4.

69 See Annex 5.1.

Authorisation procedures for loan servicers

Similarly to loan investors, the authorisation procedure for loan servicers may or may not be linked to a banking licence requirement. Alternatively, the authorisation may merely rely on a fit-and-proper check (as in the case of investors: repute of directors, capital requirements or professional insurance, IT requirements, risk control, audit, and compliance). Cross-border activity of loan servicers can also be subject to different regulatory setups (national licensing, passporting, single authorisation, etc.).

Business rules for loan servicers

The scope of activity of loan servicers may be more or less broad. It usually includes such activities as direct contact with the debtor, but may in some cases go as far as out-of-court or judicial recovery. Again, servicers' role in rescheduling re-payment of the loan may require modifications in some Member States, in order to clarify whether a banking license is required in this context. Rules on outsourcing of activities can state whether the outsourcing institution maintains responsibility and accountability. Similarly to above, loan servicers' activity will be constrained by national rules, for example on debtor protection, which will continue to be set at the Member States' level.

Protection of debtor rights, privacy and data protection

An important challenge of this policy initiative is the potential conflict with debtor rights protection and personal data protection laws.[70] Some Member States set specific conditions or limit the scope of business activity for loan purchasers and loan servicers, others govern these issues in other laws, independent from the authorisation process of these entities, or impose the same rules on banks and loan servicers. In particular, the transfer of loans could cause issues with personal data protection if the processing of data involved in the change of creditor is carried out in non-compliance with data protection rules. If the debtor becomes subject to an insolvency procedure, NPL investors have very different rights and obligations in the different Member States. Since the issue of insolvency and debtor protection is covered in a different NPL work stream, this Impact Assessment discusses the effects in terms of gaps that could emerge if licensing and conduct rules for NPL investors and loan servicers are changed. Member States that currently use authorisation procedures as a means to ensure debtor rights protection may need to enact new legislation to maintain the desired level of protection through other means, e.g. through adopting more specific borrower protection rules.[71]

Since changes to the authorisation regime of NPL purchasers and loan servicers could interfere with borrower rights, additional safeguards for the borrower could be warranted, in particular as regards consumers. As a matter of principle, borrower protection rules stemming from the contractual relationship as well as from legislation in the borrower's home country

[70] The Consumer Credit Directive has an explicit recital that assignment of credit does not change the defences a borrower had available against the original creditor, 2008/48/EC.

[71] A benchmarking exercise, dedicated peer review by Member States, country specific recommendations focusing on insolvencies issues in the European Semester.

should be maintained. In addition, these risks could also be mitigated by introducing a requirement of notification of the debtor about the change of creditor, as well as about the applicability of national and EU rules on debtor rights protection and civil law rules about loan contracts. It could also be envisaged to strengthen supervision of the entities' actual conduct to further ensure safeguarding borrowers' rights. As regards cross-border operations of NPL purchasers and servicers, administrative cooperation mechanisms for NCAs and dedicated contact points for debtor appeals located in the debtor's Member State of the debtor should also be part of the policy initiative.

5.2 Identified regulatory best practices

The different elements described above need to be combined in a consistent way, yielding a regulatory regime that would be on average lighter and more comparable across Member States. Since it is neither proportionate nor feasible in the short-to-medium run to amend parameters such as civil law and insolvency regime, they represent the external context (which will be a given) to the conduct of NPL purchasers and loan servicers in a new regulatory regime. Additional safeguards for borrowers may be required depending on the other modifications brought by the new regulatory regime. The following list identifies regulatory best practices in a number of areas. These could constitute building blocks for a consistent new regulatory regime.

Licensing requirements for investors: In terms of making market access easier for NPL investors, one approach is to not foresee licensing requirements at national level (e.g. currently in CZ, ES, HR, LV, FI). Application of this principle to all EU Member States could potentially undermine the debtor protection specifically targeted by the rules in some Member States. A compromise solution is a lighter authorisation requirement for NPL investors, using a fit-and proper approach (e.g. IE and PT use such an approach for loan servicers, see below). Such authorisation requirement allows checking whether the applicant fulfils certain general conditions when it enters the market (see examples of fit-and-proper criteria in the previous section). Beyond the usefulness of the criteria themselves to ensure a certain level of quality and protection in the market, a light authorisation regime has the merit of establishing a first contact with the supervisor. This enables the supervisor to check, to review and, if necessary, to sanction the conduct of the entity. With respect to preserving the current level of debtor rights, lighter authorisation would therefore be consistent with a stronger role of the supervisor in controlling conduct.

Use of loan servicers by investors: Some Member States have close to no specific obligation on NPL investors, but require the use of an authorised loan servicer (IE, EL). Since most NPL investors delegate debt collection to loan servicing companies, which are the only ones to get in direct contact with the debtor, this requirement does not seem to lead to disproportionate costs. Since the outsourcing mandate to a loan servicer should not discharge the NPL investor from its responsibilities, rules need to clarify obligations and define how the investor monitors the loan servicer. Therefore, the licensing requirements, as discussed in the previous paragraph, could be less stringent where the NPL investor relies on an authorised servicer. If the NPL investor performs the loan servicing itself, the rules for both loan investors and servicers (if different) need to apply to it.

Types of loans eligible for disposal: Several Member States make a distinction between loan purchasers acquiring performing or non-performing loans (BG, FR, LT, PT, RO, SK) or have special rules for loans owed by households (BG and to some extent BE, LT, NL, SI and SK). Other Member States do not make this eligibility distinction. In Member States that have different rules for the sale of performing and non-performing loans this distinction tends to lead to higher transaction costs and lower interest of investors. This may be a cause of relatively low contribution of loan sales to the decline in NPLs during the period 2015-16 in BG and PT and the absence of notable loan sales in FR.[72] The reason why some Member States have different rules is that they consider ownership of a performing loan as similar to credit granting and therefore see a need to regulate them comparable to banks. This means that such investors are required to hold a banking license. The purchase and administration of loans, however, technically does not generate new credit. Moreover, non-bank investors do not refinance themselves through deposits and hence should not be subject to the same supervision or same restrictions on leverage or minimum capital as credit institutions. In economic terms, holding and administration of an existing loan is not similar to bank business and therefore should not necessarily require a banking license.

Apart from the cases described above, Member States do not restrict the sale of loans owed by households and instead provide protection for consumers and house owners through other means than authorisation conditions for non-bank loan purchasers or limitations on whether loans owed by consumers could be sold. The wider the coverage of eligible NPL, the fewer potential distortions between market segments need to be considered. From the perspective of the bank, NPLs from households or corporations weigh equally on their balance sheet and limiting the possibility to sell corporate loans would reduce the NPL's potential market size by a third. From the perspective of a household, consumer credit and mortgage credit may be of same importance and it would be up to political preferences whether one or the other requires more safeguards in case of transfer to non-banks.

Authorisation requirements for servicers: Some Member States request authorisation of loan servicers along a fit-and-proper approach (IE, PT). They are in direct contact with the debtors and supervisors need to ensure that they comply with relevant rules relative to debtor protection, privacy and data protection. Although a few Member States do not have specific licensing requirements for loan servicing firms, such an approach might not be advisable at EU level due to the possible effects on the debtor rights. Due to risks for financial stability and importance of debtor protection, there is a strong interest to ensure that servicing firms have the organisational and technical capacity to operate in accordance with applicable laws and that they can continue business even against economic or legal headwinds. Hence, fulfilment of organisational requirements and possibly even request for indemnity insurance or loss absorbance capacity seems useful. Similar to the treatment of NPL purchasers, a lighter authorisation regime for servicers could be balanced by stronger supervisory rights.

Loss coverage of servicers: Most Member States do not request minimum capital for loan servicers. However, BG, EL and RO do and in some other Member States minimum capital requirements may emerge as consequence of the need to hold a banking license. In order to reflect the fact that loan servicers' activity is much narrower than that of credit institutions, it would be advisable to not subject them to capital requirements applicable to credit institutions. In order to secure that firms are able to compensate any damages related to their

[72] See Figure 5b or Figures A.4.4 and A.4.5 in Annex 4.

operations, one could consider a requirement of either indemnity insurance, or a capital buffer.

Borrower rights: Very often purchasers of NPLs are from a different Member State than the borrower or even from outside the EU.[73] In order to avoid that the cross-border transfer of a loan leads to uncertainty about which Member States' law applies, the standard approach is that the law that governs the contractual relationship between the borrower and the initial creditor, as well as the consumer protection rules of the borrower's home country continue to apply. This means that the borrower rights remain untouched from the transfer and the new owner cannot derive any additional rights if it is located in a country with a more creditor friendly regime. NPL purchasers and loan servicers would then need to adjust their business model and internal compliance standards to the law of the Member State of the initial loan contract, irrespective of their domicile, authorisation and passport. Currently, market participants rely primarily on consultancy firms and law firms to obtain such information. At least loan servicers set up domestic entities or cooperate with domestic firms to ensure compliance with national provisions.

Code of conduct for servicers: Ireland refers to borrower rights and to a code of conduct in its law that governs the authorisation of loan servicers. Sweden tasked its data protection authority with the authorisation of debt collection firms. Loan servicers need to observe existing legislation in Member States, especially insolvency law and borrower rights. And since they deal with personal information, they need to respect data protection laws. Other conduct rules that govern processes how they interact with debtors may also be warranted as regards their fundamental rights. If they take the form of legal obligations or enforceable codes, supervisors would be entitled to control and possibly sanction in case of misbehaviour. It is worth mentioning that some loan servicers have committed to self-set conduct rules that restrict their interactions with borrowers to certain limits, i.e. not using communication that is perceived as threatening or intrusion into privacy, or not spreading certain information. An industry association of loan servicers announced its incentive to set up conduct rules for the industry in its reply to the public consultation.

Rescheduling of loan repayment by servicers: Practice among most Member States, with notable exceptions in BG and DK, which place limits on the capacity of loan servicers in debt enforcement, is also that loan servicers can agree on rescheduling debtors' repayment of the loan outside insolvency proceedings. Often they can launch or participate in enforcement actions. It seems desirable that loan servicers do not face limitations in their efforts to reschedule the payment stream or establish a repayment plan, provided that is bilaterally agreed with the debtor. Even though this is in many regards not comparable to a new credit generation, some Member States such as AT treat it as such, which leads to a banking license requirement. Since outsourcing to external loan servicers is common practice in this business, other national practices consider that servicers' participation in debt resolution mechanisms (restructuring as well as enforcement) should not be hindered. In absence of requirements for such actions, there would, however, be a need rules ensuring that responsibility is not diluted,

[73] Tables A.5.1 and A.5.2 report the geographic origin of large NPL purchasers.

especially as regards the responsibility of the loan purchasers. Beyond these NPL-related cases, loan services would be bound by existing rules at EU and national level.

Supervision and cross-border activity: Given the lack of EU competence in supervision on this matter, national competent authorities play an important role as supervisors of loan servicers. If the regulatory regime allows cross-border activity, e.g. facilitated by an EU passport, there needs to be effective coordination between home and host supervisor. Since these activities are supervised at national level only, there are no experiences with the supervisory practice for cross-border transactions.

To facilitate cooperation host supervisors could be required to have a complaint office that would receive complaints from debtors about domestic and foreign loan servicers, with an automatic information exchange with foreign servicers' national competent authority. The home supervisor could be obliged to act once it receives a certain number of justified complaints. It could also be envisaged that the host supervisor may get the possibility to withdraw the passport. National competent authorities could make use of the Internal Market Information system (IMI) for their information exchanges.[74]

Right to information: Best practices for additional safeguards for borrower rights are early information to the debtor about the loan transfer, information about possible legal defences and complaint methods. As in several MS the NPL purchasers and/or servicers have the same obligations vis-à-vis the debtor as the originating credit institution had it could also be envisaged to oblige purchasers/buyers to explicitly recognise that they assume the same obligation. It would also be important that in cases the transfer of loans from a credit institution to a non-bank reduces borrower rights, legal gaps are addressed.

Possible best practices beyond the scope of this initiative: A number of provisions will not be touched as part of this initiative, although they have been identified as obstacles to the cross-border expansion of loan servicing and obstacles to NPL purchases. Standardisation of the legal instruments to transfer loans, other civil law provisions, debtor protection rights in national law or data protection law are outside the scope this initiative. They appear too heterogeneous to become standardised even if cross-border firms already active on different national markets would benefit from substantial cost savings if these were standardised, and the possible value added of standardisation seems uncertain. Though this limits the benefits this initiative can generate in terms of fostering cross-border market entry, existing firms active in several markets have been able to cope with these differences.

5.3 What is the baseline from which options are assessed?

In the baseline, current rules would continue. This means that specific entry barriers in some Member States would persist and conduct rules that discourage investor entry and the build-up of investor relationship with loan servicers would remain effective. Although there are no restrictions to invest in NPLs in most EU Member States, specific rules on notification to debtors, registration of collateral, localisation and licensing may effectively hold back

[74] http://ec.europa.eu/internal_market/imi-net/about/index_en.htm

investor entry into markets where they have not been active before. Especially foreign investors may remain reluctant to take exposure in smaller and lesser known markets.

The investor basis for the European NPL market would likely remain at its current size without additional incentives to boost the demand side. While the hedge fund industry recorded growth rates of almost 9% on average during 2015-17 and even double digit growth rates in 2013 and 2014, investment in private as well as in distressed debt has remained rather constant at both global and European level since 2015. Statistical data by Preqin, one of the main data collector on the alternative asset management industry, suggests that the European distressed debt market amounts currently to approximately EUR 20 - 25 billion, including part of the investors that target "special situations" (see Annex 5.1). Investment capacity of this magnitude is consistent with average NPL prices of 20 to 25% of face value and a continuation of loan sales of about EUR 100 billion per annum as observed in the last two years. Profitability in the industry will remain at the currently high rates significantly above 10% observed in the specialised investment fund industry (Annex 5.1) and in firms offering loan servicing (Figure 8 and Table A.3 in Annex 5.2).

If other measures of the NPL action plan effectively expand NPL supply, the baseline scenario means that NPL supply would move along a constant demand curve with banks offering NPLs for sale and competing for a constant investor pool. Without additional demand, banks would not be able to realise higher prices, which increases their incentive to keep NPLs on their balance sheet and evergreen them to the extent possible.

The economic consequences of the above described scenario are manifold. First, the underdeveloped NPL market is expected to mean that NPLs remain on banks' balance sheets, which constitutes an obstacle to mergers and acquisitions among banks, impairing the market-driven restructuring of the EU banking sector. Second, if banks keep high NPLs on their balance sheet, but do not have the capacity to deal with them in a sustainable way, losses from NPLs can contribute to triggering a bank failure. Third, in a situation where NPL levels would increase in some Member States, they would face limited demand and therewith limited scope to sell NPLs to investors. Finally, in case of stress in the banking sector, banks with low NPLs and a similar asset structure as those with high NPLs risk being penalised by investors in bank debt, leading to higher funding costs for sound banks. Historic episodes have shown that in times of market turmoil investors are not discriminating sufficiently between banks' different asset quality.

Recent trends in NPL volume data show that loan sales in 2015 and 2016 contributed to a decline in the stock of NPLs in the EU by about EUR 200 billion. The exact contribution is impossible to be quantified because, inter alia, some loan sales also covered performing loans and there was no information about the breakdown, and because some loans were sold by AMCs so they did not reduce NPLs on the banks' balance sheet in the year they were sold, but earlier.[75] The EU's NPL ratio fell by 1.4 percentage points over these two years to 5.1% at end

[75] For example, one of the largest sales in 2017 related to a portfolio by UK asset manager UKAR and compromised a face value of 11.8 billion GBP in 104000 performing loans that originated from Bradford and Bingley before the banks was taken in public ownership in 2010. See http://www.ukar.co.uk/media-centre/press-releases/2017/31-03-2017?page=4.

2016.[76] Thus, upon continuation of this trend, which however cannot be taken for granted, it would take 3 to 4 years to reach a ratio of 2.2% and 1.8% in the EU. For comparison, the NPL ratio amounted to 1.7% in the US and in Japan in 2016 while the EU NPL ratio in 2008 was 2.2%.

The baseline assumption of a trend continuation means that loan sales will remain absent or small in a number of Member States and that NPL ratios are likely to remain at double-digit levels (see Figure 10) in Member States such as CY, EL, PT, BG. The baseline therefore implies risks to financial stability in those Member States where NPL ratios are high and for the EU banking sector as a whole even if the EU average NPL ratio would have fallen to an acceptable level after 3 to 4 years.

Figure 10: Development of NPL ratio in Member States with small or no loan sales

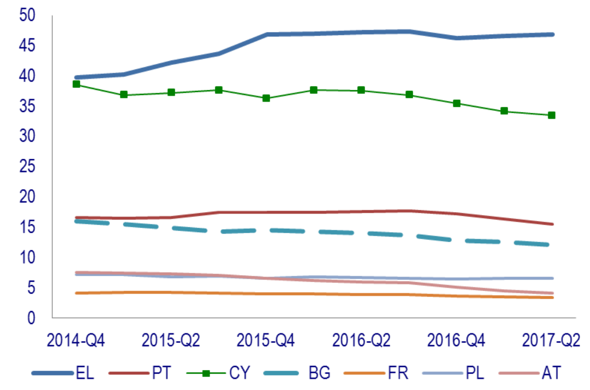
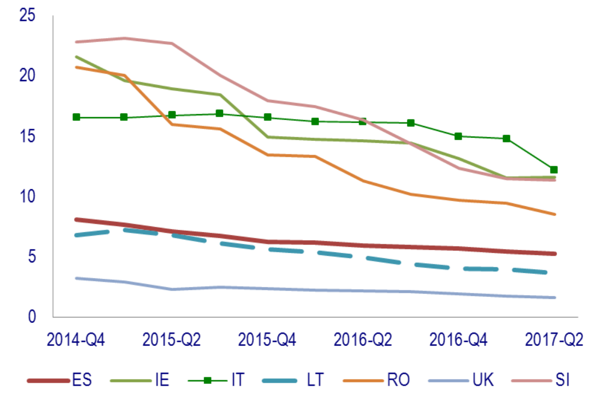


Figure 11: Development of NPL ratio in Member States with loan sales



Note: Stand-alone banks and foreign controlled subsidiaries and branches. Extrapolation of missing observations by Commission services.
Source: ECB.

5.3 Description of the policy options

This section describes the three policy options that will be assessed in section 6. Table 4 below provides a broad overview of the coverage of these options across the main framing dimensions described in section 5.1. For each dimension and under each option, the table states whether the area would be covered by rules at national level, EU level, or both. The main features of each option are the listed under each area.

Table 4: Overview of the regulatory implications of policy options across five dimensions

	Baseline	Option 1 – Non-binding principles	Option 2 – Minimum standards	Option 3 – Single rulebook
Purchaser authorisation - Authorisation criteria	**National** -	**National** Recommend light authorisation	**EU** Broad fit&proper criteria Authorisation	**EU** Specific fit&proper criteria Authorisation

[76] From 6.7 to 5.3% with ECB data, from 6.5 to 5.1% with EBA data.

	Baseline	Option 1 – Non-binding principles	Option 2 – Minimum standards	Option 3 – Single rulebook
- If use of authorised servicers	-	-	process lighter	process lighter
Purchaser business rules	**National**	**National**	**EU**	**EU**
- PL and NPL purchases	-	Recommended to authorise PL	PL purchases authorised	PL purchases authorised
- Loan rescheduling	-	-	No special licensing needs	No special licensing needs
Servicer authorisation	**National**	**National**	**EU**	**EU**
- Authorisation criteria	-	Recommend light authorisation	Broad fit&proper criteria	Specific fit&proper criteria
- Loss coverage	-	-	Either insurance or capital buffers	Common capital buffers
Servicer business rules	**National**	**National**	**EU & National**	**EU**
- Compliance with legislation	-	MS discretion	Enforceable conduct rules	Enforceable conduct rules
- Loan rescheduling	-	MS discretion	No special licensing	No special licensing
- Supervision	-	National supervision rules	National supervision rules	Common supervision rules
- Cross-border activity	-	Freedom to establish physical presence	Passporting, home/host cooperation	Passporting, home/host cooperation
Borrower rights, privacy and data protection	**EU & National**	**EU & National**	**EU & National**	**EU & National**
- General rights	National rules	National rules	National rules	National rules
- Right to information	-	-	Minimum standards	Common rules
- Privacy and data protection	EU data protection rules, national laws	EU data protection rules, national laws	EU data protection rules, national laws	EU data protection rules, national laws

5.3.1 *Option 1 - Non-binding common high-level principles*

A first option would be to establish non-binding high-level principles that would mostly target entry conditions and conduct rules of NPL investors and loan servicers. These principles cover criteria that investors would need to fulfil to serve as eligible counterparts for banks in NPL transactions and that loan servicers would need to fulfil to provide services to NPL investors. These principles would target areas that are most detrimental to market entrance and that differ strongly across Member States. It would be particularly useful to target a reduction in the regulatory burden in those Member States that have a high NPL ratio and few NPL sales: EL, PT, HR, CY, possibly also IT[77], HU and SI.

In order to stimulate participation in NPL and loan servicing markets, the principles would favour a lighter entry authorisation approach for both investors and servicers. EU principles for loan servicers would include a licensing requirement, the freedom to establish a physical

[77] Italy recorded a strong acceleration in loan sales in 2016 that continued in 2017.

presence in any EU Member States and the respect for local consumer and data protection rules. The principles would not specifically address the Member States that require a banking license and physical presence of NPL investors, although the recommended approach would be to use lighter entry authorisations. It would further be recommended to lift limitations on the type of loans that non-banks can acquire, i.e. propose equal possibilities for banks to sell performing and non-performing loans or special types of loans, such as secured loans or loans owed by consumers. The principles could also suggest to Member States under which conditions loan servicers can reschedule loan repayments without generating a new loan. In order to reduce administrative delays, these rules would usefully also determine maximum requirements for public authorities to deal with them.

By nature, non-binding common principles would not introduce additional obstacles in those Member States in which market entry is already simple. This could be reached through non-legislative measures such as guidelines supplemented by country-specific recommendations in the EU semester and/or targeted support by the Commission's Structural Reform Support Service to those Member States most in need. While this option is non-binding on Member States, it would be recommended that Member States that deviate from the common principles adjust their national law accordingly. In cases where Member States establish an asset management company (AMC) that outsources the management of loans to third-part loan servicers and conducts auctions of NPLs, they could implement the principles by incorporating them into the eligibility criteria for loan servicers to provide services to the AMC and for NPL investors to participate in the auctions.

5.3.2 Option 2 - Binding common minimum standards with passporting

A second option would be binding common minimum standards for entry conditions and business rules for investors and loan servicers, including the possibility of operators established according to these standards in one Member State to provide services in other Member States ("passport"). These rules would be oriented along the best practices listed in section 5.2, but would not be defined as a general principle, but include minimum and/or maximum conditions at EU level, that Member States would need to respect when transposing the EU rule into national law. Member States would need to transpose these standards in national law and need to recognise authorisations of NPL investors and loan servicers from other Member States.

These rules would cover more subject matters as under Option 1, and would be more specific. They would establish criteria that investors would need to fulfil to serve as eligible counterparts for banks in NPL transactions and for loan servicers as counterparts to NPL investors. These rules would be based on fit-and-proper criteria (repute, capital requirements or professional insurance, complemented by organisational, IT, risk and compliance requirements) and would determine authorisation procedures and conditions for NPL investors and loan servicers. They would also govern outsourcing possibilities and limitations thereof. Another covered area would be the scope for loan servicers to re-schedule debt and their relationship to loan owners. The standards would require equal treatment of performing and non-performing loans or special types of loans, such as secured loans or loans owed by consumers. NPL investors would be incentivised to use authorised loan servicers. Both NPL investor and loan servicers would be obliged to comply with the civil law of the host country, when acting cross-border and to allow host supervisors to review their conduct. They could also commit Member States to reduce administrative burden of the licensing process and to refrain from enacting some limitations for NPL investors or loan servicers, such as the domiciliation request or the need for a banking license.

They would also commit applicants to not derive additional obligations from the borrowers than they had vis-a-vis the credit-originating bank. The standards would also set limits on what applicants can or cannot do, with enforceable conduct rules that supervisors can monitor and enforce. Since civil law provisions will not be altered, there are limits to additional safeguards that EU standards can introduce. It is, however, envisaged to set up cooperation among supervisors in home and host countries, so that complaints by borrowers about inadequate conduct can be effectively followed up by competent authorities.

Market entry would be stimulated because potential investors and loan servicers could apply for authorisation in one Member State, and would not have to request additional entry authorisation in other Member States.

5.3.3. Option 3 - Binding single rulebook with passporting

A third option would be to harmonise entry and conduct rules in the EU for investors and loan servicers in the EU. This would result in uniform entry conditions in all EU Member States, which would spur market participation and allow the realisation of scale economies. The legal instrument would establish common specific fit-and-proper requirements that Member States require applicants to fulfil and would equally commit Member States to refrain from setting further national licensing and business requirements on NPL investors and loan servicers beyond the common EU rules and the applicable national laws as regards borrower rights.

The legislative instrument would introduce specific licensing and registration requirements for those investors that are not already authorised in the EU, for example as alternative investment fund. Financial firms and investment fund managers already authorised in the EU or other countries would not need special authorisation. Hence, only non-financial firms, private individuals and firms in specific jurisdictions[78] would need to apply. Eligibility criteria should be commensurate to the needs, for example covering fit-and-proper criteria and the obligation to respect all the national consumer, debtor and data protection rules. No distinction would be made between performing and non-performing loans or for special types of loans, such as secured loans or loans owed by consumers. In case the acquired NPL portfolio contains also underperforming or performing loans, there would be an obligation to outsource loan management to an authorised loan servicing firm. The rulebook would also include rules that govern the relationship between investors and loan servicers.

The legislative instrument would give a common definition of loan servicing, which could also be positive for market entrance because it would eliminate legal uncertainty. It would establish licensing requirements similar to those existing in some Member States, but with a larger number of loan servicers. These requirements should ensure that loan servicing firms are run by trustworthy managers and have sufficient IT and logistical capacity to offer loan servicing in a sustainable manner. Since NPL portfolios often contain also underperforming or performing loans, some criteria required in Member States for banking licenses should also be considered, for example those linked to bank secrecy. This would also contribute to a level-playing field between banks' in-house management of loans and that in loan servicing firms.

[78] For example if domiciled in tax havens.

Since the former are regulated, it would be inconsistent if the latter were not. The legislative instrument would request some fit-and-proper criteria for loan servicers, possibly supplemented by conduct rules on appropriate behaviour vis-à-vis debtor and data protection.

The binding standards would broadly cover the same issues as option 2. However, under this option the standards on these matters would be fully harmonised and Member States could not introduce more stringent standards to goldplate the common rules. The legislative initiative would also bring additional harmonisation of the supervisory framework. An EU Regulation would be the suitable legal tool to accomplish this.

5.4 Options discarded at an early stage

A less intrusive intervention than changing the regulatory environment would be to set up an information platform that stores rules governing market entry for NPL investors and loan servicers in all Member States. Such a register would be accessible for potential market entrants via a website. Maintaining this website could be done centralised by a European body, such as EBA or ECB/SSM, or decentralised by public authorities in the Member State coordinated via a common entry point or even by AMCs that exist or come into existence in Member States. Member States would need to ensure that the information is factually correct and updated if necessary. The institution maintaining and coordinating the website would have the task of ensuring standardisation of the presentation of national rules.

Such an information platform would be complementary to the data standardisation project in the Council Action Plan. Rather than facilitating potential buyers to assess the values of the loans they envisage to buy in a transaction with banks, it would reduce search and information costs for administrative barriers, thereby helping firms that consider entering NPL and/or loan servicing markets. It would follow the same approach as the single digital gateway (SDG), which aims to improve online availability, quality and findability of information and assistance services on EU rights and national rules concerning the operation and movement in the EU.[79]

The option to establish an information platform is not further pursued because the benefits of reducing search costs for licensing conditions seem marginal compared to other search costs NPL investors and loan servicers have if they enter the market. While the costs of setting up such a structure would also be small, the value added is unclear. Member States that see value in providing such information can do so. For example Portugal is currently venturing this. Moreover, it is not clear whether the advantages of centralisation through an information platform are higher than information provision through competitive private firms. The information platform would crowd out the provision of the same service by consultancy firms.

Table 5: **Maintained and discarded options** - Standardise and simplify entry and conduct rules for potential NPL buyers and loan servicers

0	Baseline: no policy action at EU level	√
1	Non-binding common high-level principles	√

79 See https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-256-0_en.

2	Common standards with passporting	√
3	Single rulebook and common market supervision	√
4	Establish information platform to register national rules	Discarded

√ := Option maintained and discussed below.

6. WHAT ARE THE IMPACTS OF THE POLICY OPTIONS?

As indicated in the introduction, there is a general need to reduce NPL levels in European banks. The positive economic impact of reducing NPLs from banks' balance sheets will be an increased lending capacity of banks and improved financial stability resulting in increased market confidence, both likely to result in increased economic growth.

The different policy options address a narrow set of actors, consisting of the selling bank, the potential buyer, the loan servicer and the ultimate debtor. The main impact would therefore relate to these stakeholders.

The bank's sale of the loan to a non-bank may potentially affect the borrower and his/her rights. A positive example of a loan transfer beneficial to borrowers would be if the loan purchaser or servicer offered distressed debtors a more suitable payback profile of their loans. By way of negative example, it may also be that the loan purchaser or servicer would treat the borrower more strictly than the credit-originating banks (e.g., due to lesser reputational risks). However, even if the law applicable to the loan purchaser (e.g. the banking prudential framework would be replaced by another framework applicable to the buyer) changed with the sale, the same civil and commercial law, including the safeguards in the consumer protection rules, would continue to apply to the credit agreement based on which the loan is granted.

In view of the above, the transfer of loan from a bank to a non-bank investor does not change contractual obligations of the borrower. However, the change of the creditor means that borrowers are facing a new counterpart with whom they did not conclude contract, who may be less regulated than the originating bank and/or located and regulated in another Member State. Protection of borrowers is the most common reason for existing authorisation procedures in the Member States.

Similarly, information-sharing between investors and loan servicers could conflict with data privacy and business secrecy or, depending on the business model of the loan servicer or investor, lead to risks of excess profiling. This initiative therefore needs to ensure that purchasers and loan servicers comply with data protection rules in the country where the credit was originated.[80]

Although the coverage of the policy options is limited to authorisation of loan purchasers and loan servicers and lightening a few selected behavioural constraints, such action at EU level

80 Issues related to data are expected to improve with the application of the General Data Protection Regulation as from May 2018 and the harmonisation of data protection rules resulting therefrom.

may impact on Member States rules. For example, those Member States that require banking licenses (DE, FR, HU, MT, AT, SK) would no longer be able to do so; those that have different licensing regimes for performing and non-performing loans (BG, FR, PT, RO) would be expected to change the rules. A number of Member States (BE, BG, ES, HU, FI) would need to review the constraints they had put on some investment funds to buy NPLs and BG may need to generalise the permission to transfer consumer loans. Member States that have no specific authorisation regime for NPL investors and/or loan servicers (i.e. CZ, EE, ES HR, LT, SI, FI) would need to designate competent authorities in the transposition of the law.

Other rules in Member States would remain unchanged and would constitute a limit to the conduct of cross-border NPL investors and loan servicers. For example, BE, SI and SK could keep the condition that debtors consent is required, BG and DK their restrictions on debt enforcement[81]. Mandatory notification, notarial certification and registration is required in many Member States and untouched from the coverage of the policy options.

Direct environmental impacts are not expected, while indirect effects would occur only under specific circumstances. For example, a more dynamic NPL secondary market and better possibilities for banks to offload them should create more space for bank lending to environmentally-friendly, or more broadly sustainable projects. Moreover, since these projects are not immune to become non-performing, a better NPL market also allows banks to sell them, which might increase their willingness to fund them in the first place.

[81] The proposal to introduce accelerated extra-judicial collateral enforcement will also lead to change in the capacity of creditors to enforce corporate debt.

Figure 12: Assessment of effectiveness and efficiency

Address failure in (national) NPL markets	
Facilitate entry in Member States with high NPLs and material obstacles to market entry	To support banks in specific Member States to sell NPLs
Foster entry of smaller firms	To support smaller banks to sell smaller portfolios of NPLs
Foster a single NPL market	
Equal treatment across markets in Member States	To encourage cross-border expansion of NPL purchasers and loan servicers
Realise scale economies from cross-border operation	To encourage cross-border expansion of loan servicers and help NPL purchasers realise lower costs for loan servicing
Enhance competition the entry of foreign firms	To foster competition among NPL purchasers and loan servicers
Safeguards for borrower rights	
Ensure efficient supervision	To prevent misconduct of NPL purchasers or loan servicers vis-à-vis borrowers
Costs of adjustment of laws that protect borrower rights	To ensure that borrowers rights are not undermined by a change in authorisation rules

6.1 Option 1 - Non-binding common principles for NPL investors and loan servicers

The option could be implemented relatively quickly if pursued outside legislation at EU level. For example, the implementation could build on guidelines agreed by Member States. Whether such guidelines are able to deliver a quick reduction in the NPL ratio would depend on whether those Member States most concerned are willing and able to amend national legislation along the lines set out in the common principles. This represents the major risk and drawback of this option. At European level, Member States could be incentivised to take action through country-specific recommendations under the European semester, through an accessible list of best practices, or via technical support from the Commission's Structural Reform Support Service. Efforts towards raising political awareness and creating political acceptability for related legislative measures would also be helpful.

Address failure in (national) NPL markets

Common principles would aim to address the most material entry barriers, such as those linked to the requirement to apply for a banking license or to establish a local entity. Consequently, market entrants would benefit from cost savings from less demanding requirements and faster administrative processes. Monetary cost savings might be in the order of a hundred thousand euro if a banking license or structure of a securitisation vehicle is no longer required and there may also be further cost savings if no local entity has to be set up or capital requirements are lower.[82] Still, assuming a reasonable adoption of the initiative by Member States, the monetary cost savings are dwarfed by the large returns in NPL transactions.[83] Though actual cost savings are incremental, it could contribute to foster participation in so far underdeveloped markets. Hence, increased market entry is expected to be concentrated in countries with currently high requirements on the applicant, with long administrative delays and without meaningful loan sales.

Since entry costs are mostly fixed costs and have a sunk cost character, the magnitude of the benefits would be higher for market entrants that are smaller in size and have lower capital positions. Consequently, common principles are likely to constitute a particular incentive for small firms to enter previously ignored markets. One possible business strategy for such firms would be to specialise on bidding for smaller banks' portfolios.

Foster a single NPL market

Since implementation of the common principles would lead to convergence in standards across Member States, treatment of NPL investors and loan servicers would become more equal. In those EU Member States where existing rules already fulfil common principles, potential market entrants would neither face lower costs nor better incentives, but firms based in these Member States would face lower barriers to expand activity to markets with hitherto higher entry barriers. Hence, EU firms that consider expanding their NPL purchasing or loan servicing activity would be immediate beneficiaries of lower entry costs. Similar benefits would emerge for such firms based in third countries.

While helping to reduce entry costs and to let market conditions to converge somewhat, common principles would not create a single secondary NPL market because not all Member States may follow them fully. They could for example maintain or introduce different rules for sales of performing and non-performing loans or have special rules for different types of loans even if the common principles contained a clause that requested equal treatment of all types of bank loans. Moreover, non-binding common principles would not allow introducing a passport and would therefore not allow firms to operate in other Member States without still meeting national authorisation requirements in each Member State, and these authorisation requirements will still diverge to a certain extent. As a stand-alone measure, the reduction of burden in relation to the common principles is unlikely to generate a large incentive for foreign NPL investors and loan servicers to enter new markets. It may nonetheless contribute to more entry at the margin, especially if combined with other policy measures that lead to a

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[82] The available compliance data is short, not-representative and shows strong variation across Member States and firms (see Annex 3.2). In order to obtain a better view on compliance costs, DG FISMA will launch an external study to update and expand upon the results of Europe Economics 2009).

[83] The literature points to a target profit margin of about 15% (Ciavoliello et al. 2016), actual returns in debt funds investing in distressed debt are about 10% (see Table in Annex 5.1). With an average face value of an NPL transaction of EUR 500 million and assuming a transaction price of 20%, expected revenues would be in the ballpark 10-15 million.

greater supply of NPLs, lower information and transaction costs or higher recovery values of the underlying loans.

Specific for loan servicers: The reduction of entry costs for loan servicers through common principles should incentivise some loan servicing firms to expand their cross-border activity. The greater ease to establish a loan servicing firm, the availability of more loan servicers and lower costs of loan servicing through more competition among loan servicers would collectively further boost the NPL markets.

Impact on borrowers

If under this option, more NPL are sold from banks to third party entities, more borrowers are likely to face a third-party loan servicer. The latter would be operating under supervision of the debtor's national authorities and in accordance with national rules. Member States will therefore be able to maintain the desired level of borrower rights, even in cases where the authorisation regime becomes lighter as a result of the implementation of the principles (also discussed in the following section).

Safeguards for borrower rights

In those Member States where the implementation of common principles would lead to lighter authorisation regimes, it will be up to national competent authorities to ensure adequate supervision, for example by effective follow-up to borrower complaints.

This option would not have a large impact on supervision and the costs thereof. Member States and those in which a larger number of market participants will be active would receive more applications and need to supervise more market participants. They would need to build up additional administrative capacity.

The main advantage of this option would be that it would leave the highest degree of flexibility to Member States on how to best accommodate them to other applicable laws, in particular those affecting borrower rights. When implementing the common principles, Member States could review whether they entail gaps in borrower rights and adjust either these laws or those laws that implement the EU principles accordingly. This could cause some costs for the public sector.

All in all, the immediate economic effects coming from common principles seem limited. For instance, if the reduction of entry barriers helps kick-start market developments in some Member States, other Member States could follow suit. In addition, once tangible benefits from developing NPL markets are realized, Member States may consider reducing entry barriers further. These indirect implications cannot be quantified.

Table 6: Impact of non-binding common principles (assessment relative to baseline)

<table>
<tr><th></th><th>NPL investors</th><th>loan servicers</th></tr>
<tr><td>Address failure in (national) NPL markets</td><td></td><td></td></tr>
<tr><td>Facilitate entry in MS with high NPLs and material obstacles to market entry</td><td colspan="2">+</td></tr>
<tr><td>Foster entry of smaller firms</td><td colspan="2">+</td></tr>
<tr><td>Foster a single NPL market</td><td></td><td></td></tr>
<tr><td>Equal treatment across markets in Member States</td><td colspan="2">+</td></tr>
<tr><td>Realise scale economies from cross-border operation</td><td>0</td><td>++</td></tr>
<tr><td>Enhance competition the entry of foreign firms</td><td colspan="2">+</td></tr>
<tr><td>Impact on Borrower</td><td colspan="2">-</td></tr>
<tr><td>Safeguards for borrower rights</td><td></td><td></td></tr>
<tr><td>Ensure efficient supervision</td><td colspan="2">-</td></tr>
<tr><td>Costs of adjustment of laws that protect borrower rights</td><td colspan="2">-</td></tr>
</table>

6.2 Option 2 - Binding common minimum standards with passporting

Address failure in (national) NPL markets

The advantage of common standards and passporting would be that investors and loan servicers could establish entities in other countries or provide services across the EU/ EEA without the need for further authorisation if they are already active in one country. The resulting saving of additional compliance costs, legal certainty and avoidance of administrative delays would have a positive impact on the incentive of incumbent market players to expand activity to other Member States. Since the magnitude of cost and time saving would depend on the Member State targeted, market entry would be over-proportionally stimulated in Member States with currently high entry barriers.[84] This effect would be larger than under option 1.

A further advantage is a more positive impact on market structures than in option 1. Smaller investment firms or investment funds considering to enter the market or to expand activity cross border would benefit more than larger ones, which are already in the market, because the fixed-cost character of entry costs is relatively more important for smaller amounts invested. Hence, the measure could stimulate competition for smaller NPL portfolios. While the immediate objective of the measure would be to increase competition among investors for NPL portfolios, a uniform passporting/mutual recognition rule would also increase competition on the supply side as investors would face more offers from banks.

84 A quantitative estimate of cost and time is not possible because of lack of data. By means of example, the first loan servicers in Greece were authorised in July 2017, one and a half year after the dedicated law on loan servicers had become effective. First NPL transactions in Greece occurred in 2017.

Foster a single NPL market

Legal differences across Member States could be further reduced, as compared to the previous option, if entry conditions for investors and loan servicers are defined in an EU Directive and the standards do not provide scope for different rules for performing and non-performing rule or specific forms of loans. It is possible that the use of passporting will only be possible if entry conditions converge in Member States. This would also imply they could become stricter in those Member States with currently rather lenient ones. In this case, the common standards with passporting/mutual recognition are expected to still deliver lower entry barriers on EU average than under the baseline. A possible discouragement seems less relevant for loan servicers, because domestic licensing or registration is standard in most Member States.

The availability of a passport could help attract third-country investors because one-stop licensing would allow them to access multiple EU NPL markets from a single subsidiary. In particular, this would incentivise NPL investors to enter markets in which licensing is currently overly cumbersome.

Specific for loan servicers: The possibility to expand activity across borders via passporting seems particularly beneficial for the loan servicing sector, where the scope to realise scale effects is significant. The likely ultimate outcome is lower loan servicing fees charged to NPL investors.

Impact on borrowers

Under this option, NPL sales to third parties would become more common. Borrowers would be likely to face a third-party loan servicer, some of whom would be authorised in another Member State and operating in the debtor's country with a passport. Borrowers would be protected from misconduct of a NPL purchaser or loan servicer through NCAs supervision in the debtor's country, in cooperation with the servicer's home country NCA. Some negative impacts on the borrowers' welfare could result from the fact that the home-host supervisor cooperation could be less effective in dealing with misconduct from loan servicers operating under a passport compared to a situation with national authorisation and supervision. These problems would be most likely in the first years of the cooperation framework, and would be expected to disappear over time.

Safeguards for borrower rights

Supervisors in host countries would need to set up effective procedures to deal with complaints from borrowers and reinforce cooperation with supervisors in home countries, including options to withdraw passports or licenses in case of lack of compliance with rules in host countries.

This option would therefore have an impact on supervision and the costs involved because competent authorities in Member States would need to supervise more cross-border firms. This entails higher complexity of actual supervision, higher responsibility vis-à-vis host countries and coordination needs with authorities in host countries. Competent authorities in Member States with low entry barriers could expect to receive more applications from firms domiciled outside the EU and follow up supervision of these entities, which are likely to be active in other EU Member States too. The regime with passport may therefore lead to higher costs of supervision than in option 1.

The binding common standards could lead to gaps in the legal protection of borrowers if they interact with other laws at national or EU level to the detriment of the borrower. This would be the case, for example, if the authorisation of domestic loan servicers had explicit provisions to conduct rules and the common standards had not or if the national laws impose specific conduct with respect to data protection and the EU rules do not. Implementation of the Directive would give some leeway for the Member State to transpose the rules in a suitable manner, within the limits the Directive allows. For cases beyond this, Member States would need to adjust other laws to maintain the desired status of borrower rights. The likelihood of such adjustment to be necessary is higher than in option 1.

The legislative process for common standards with passport/mutual recognition may be lengthy if Member States consider that maintaining their country specific regime is important. In addition to the time required to engineer agreement at EU level, Member States' implementation would be time-consuming.

Overall, option 2 is more effective than option 1, but at the expense of higher likely hosts to preserve borrower rights and more intrusion in Member States existing legislative framework and sovereignty.

Table 7: Impact of binding common principles with passport (assessment relative to baseline)

<table>
<tr><th></th><th>NPL investors</th><th>loan servicers</th></tr>
<tr><td>Address failure in (national) NPL markets</td><td></td><td></td></tr>
<tr><td>Facilitate entry in MS with high NPLs and material obstacles to market entry</td><td colspan="2">++</td></tr>
<tr><td>Foster entry of smaller firms</td><td>+++</td><td>++</td></tr>
<tr><td>Foster a single NPL market</td><td></td><td></td></tr>
<tr><td>Equal treatment across markets in Member States</td><td colspan="2">++</td></tr>
<tr><td>Realise scale economies from cross-border operation</td><td>0</td><td>+++</td></tr>
<tr><td>Enhance competition the entry of foreign firms</td><td colspan="2">++</td></tr>
<tr><td>Impact on Borrower</td><td colspan="2">--</td></tr>
<tr><td>Safeguards for borrower rights</td><td></td><td></td></tr>
<tr><td>Ensure efficient supervision</td><td colspan="2">--</td></tr>
<tr><td>Costs of adjustment of laws that protect borrower rights</td><td colspan="2">--</td></tr>
</table>

6.3 Option 3 - Single rulebook and common market supervision

Address failure in (national) NPL markets

In order to become quickly effective, the Regulation would not strive to harmonise the legal tools available to transfer loans. In view of the different legal traditions in Member States, this appears too challenging to be accomplished within a reasonable time span. Moreover, changing the fundamentals of the civil legal system does not look proportionate to the underlying problem and it does not seem achievable politically within a reasonable time span.

Instead, the single rule book would harmonise entry rules, thereby undo specific differences in entry conditions across Member States and particularly the costly obstacles to entry that exist in a few Member States. The single rule book would therefore particularly improve entry conditions in Member States facing high entry barriers by removing entry barriers that result for example from the need to obtain a banking license, to operate via a local entity or to use specific legal vehicles to hold NPLs such as a special purpose vehicle in securitisation arrangements or a specially created investment fund. The removal of some of these obstacles would significantly reduce entry costs and it could make investors more responsive to the NPL supply by banks. In this respect, the single rule book would be more effective than minimum standards.

Participants already active in one Member State would face no additional administrative costs or administrative delays when expanding activity to other Member States. Market entrants could realise monetary cost savings as high as in the case of a Directive and, compared to the baseline, particularly if they use the passport to expand activity to Member States with currently high entry costs and long administrative delays.

This would lead to a significant increase in the NPL investor base if investors expect supply to be sufficient and profit opportunities to be satisfying. As an isolated measure, the lowering of entry costs is expected to have a limited impact on entry decisions given that entry costs are small compared to other costs in the purchase process such as search and information costs to evaluate the value of the NPL portfolio for sale, costs for legal advice and compliance with different legal instruments in the Member States to transfer loans.

The market conditions for loan servicers will depend not only on the introduction of a passport but also on the demand for their services by NPL investors. The latter effect is particularly important in the short run. Over the longer term, the benefits of a more competitive market for loan servicing would become increasingly important. One example is the securitisation of loans, where lower costs of loan servicing contribute to more securitisation activity. Banks would also benefit from lower costs by outsourcing loan servicing to specialised firms. Finally, loan servicers are more IT intensive and smaller in size than banks so they may contribute to the pace of innovation and to technical progress.

The impact on the market structure is uncertain. Larger and more efficient secondary markets for NPLs could foster structural change in the banking sector of those countries with a high stock of NPLs.[85] As regards the impact on NPL investors and loan servicers, a single market framework could accelerate market adjustment, possibly encouraging entry of smaller NPL investors. The case is less clear cut for loan servicers. On the one hand, the standardisation of market entry may incentivise smaller firms to enter, accelerating the trend of the last years. On the other hand, the loan servicing market has dynamically evolved in the last years with a number of firms merging or being acquired. Hence, higher competitive pressure may lead to on average loan servicers.

[85] For a review of the channels through which NPLs impair merger and acquisitions activity in the banking sector, see the special feature in ECB (2017b).

Foster a single NPL market

The uniformity of rules would establish a level playing field of NPL investors and loan servicers, which is conducive to an intensification of competitive pressure among them. It would also avoid any market segmentation for different types of loans such as performing or non-performing-loans or loans owed from specific counterparts. This should contribute to lower bid prices for NPL portfolios.

Similar to the previous option, the single rule book might lead to tighter rules in Member States with currently lenient ones. For Member States with low NPL levels and consequently a low NPL supply, this measure would be close to neutral. These Member States would become beneficiaries in case NPL problems were to emerge in the future.

Nonetheless, compared to the status quo, harmonised rules would set an incentive for NPL investors to bid for NPLs from banks domiciled in different Member States because cross-border activity will be facilitated. Hence, it will also bring advantages for incumbent market participants. Moreover, the single rulebook helps attract market entry from smaller NPL investors and third-country investors. The former would benefit because the reduction in compliance costs has an over-proportionate effect for them, the latter because they face a larger market. The single rule book may also have a strong signalling effect on foreign investors. Similar effects may also emerge under option 2, but at lower intensity.

Harmonisation of business conditions is expected to have a considerable impact on loan servicers as they would be able to economise on licensing costs when entering several Member States. To the extent that legal uncertainty from different definitions of loan servicing across Member States deterred the expansion to new markets, a common definition would eliminate this obstacle. In addition, the resulting notion of a single market may induce third-country loan servicers to enter EU markets because licensing will be unified and therefore easier. This measure would reduce the costs for an established loan servicer to expand to other EU markets and it would also incentivise third-country loan servicers to enter the EU market.

Since loan servicers' business model is characterised by scale effects, a single market regime is likely to yield lower average costs than option 2. The cursory information about profitability in loan servicing firms active in EU Member States suggests that especially firms are more profitable the more assets they manage (see Figure 8 and Table A2 in Annex 5.2).

Cross-border expansion of EU firms and market entry of third-country firms would also lead to more competition among loan servicers. Both effects are expected to reduce the costs incurred by NPL investors when they delegate debt collection to a third-party loan servicer. The passport would also increase the pool of loan servicers an NPL investor can choose from when bidding for an NPL portfolio. The benefits from new market entries should be particularly visible in Member States having low numbers of incumbent loan servicers, especially if these are owned by competing NPL investors.

Impact on borrowers

Under this option, NPL sales to third parties would become more common. Some borrowers would be likely to face a third-party loan servicer, some of whom would be authorised in another Member State and supervised by a NCA in a different Member State according to a common rule book. Borrowers would be protected from misconduct of a NPL purchaser or loan servicer through NCAs supervision in the debtor's country, in cooperation with the servicer's home country NCA. There could be negative impacts on the borrowers' welfare due to ineffective home-host supervisor cooperation. As a result of more harmonised supervision rules across EU Member States, it should be less severe and disappear faster over time than under Option 2.

Safeguards for borrower rights

As compared to the previous two policy options, there could be a need for further convergence of business practices from a single rule book to be followed by national authorities in the authorisation and supervisory process or indeed a single institution in charge of the authorisation process and supervision.

When a network of competent national authorities is in charge of authorisation and supervision, it will be a challenge to establish harmonised supervisory practices. A single supervisory body may have lower coordination needs, but would rely on expertise on the ground and need to consider the impact of legal rules for the transfer of loans and debt protection provisions that remain national. It is not evident whether supervisory costs would be higher or lower than in the case of a Directive with passporting rights.

To ensure political acceptability of an easier market access for foreign loan servicers, it would be warranted to include in the Regulation obligations for loan servicers to observe local consumer and data protection rules. Alternatively, the Regulation could specify enforceable conduct rules for loan servicers.

In Member States that used to ensure debtor protection through the authorisation and supervision of NPL investors or loan servicers, there could be a need to implement new laws that uphold the desired level of debtor protection through other means. The required adjustment of national law and its implementation will entail one-off costs at national level. These are likely to be higher than in case of a Directive because Member States would have no possibility to consider them in the transposition of the Directive, but would need to channel all adjustment needs into amendments to other laws.

Overall, option 2 is more effective than option 2, but at the expense of higher likely hosts to preserve borrower rights and more intrusion in Member States' existing legislative framework and sovereignty.

Table 8: Impact Single rulebook and common market supervision (assessment relative to baseline)

<table>
<tr><th></th><th>NPL investors</th><th>loan servicers</th></tr>
<tr><td>Address failure in (national) NPL markets</td><td></td><td></td></tr>
<tr><td>Facilitate entry in MS with high NPLs and material obstacles to market entry</td><td colspan="2">+++</td></tr>
<tr><td>Foster entry of smaller firms</td><td>+++/++</td><td></td></tr>
<tr><td>Foster a single NPL market</td><td></td><td></td></tr>
<tr><td>Equal treatment across markets in Member States</td><td colspan="2">+++</td></tr>
<tr><td>Realise scale economies from cross-border operation</td><td>0</td><td>+++</td></tr>
<tr><td>Enhance competition the entry of foreign firms</td><td>++</td><td>+++</td></tr>
<tr><td>Impact on Borrower</td><td colspan="2">---</td></tr>
<tr><td>Safeguards for borrower rights</td><td></td><td></td></tr>
<tr><td>Ensure efficient supervision</td><td colspan="2">---</td></tr>
<tr><td>Costs of adjustment of laws that protect borrower rights</td><td colspan="2">---</td></tr>
</table>

7. HOW DO THE OPTIONS COMPARE?

Figure 12 listed criteria against which the effectiveness and efficiency of the different policy options are assessed under each option's assessment in the previous section. The Table 9 below summarises these individual assessments and makes it possible to do an overall comparison of the options.

Overall effectiveness was assessed by aggregating the benefits of the options in addressing failures in NPL markets and in fostering a single market. Overall efficiency was evaluated by comparing these benefits to the aggregate costs in terms of maintaining the same level of borrower rights. See Annex 4.4 for the detailed calculation. Coherence of the options was assessed with regard to broader Commission priorities[86], but also in the specific context of the related measures of the Council NPL Action Plan (see the section 1 for a discussion of the interdependencies between the various initiatives of the Action Plan). Proportionality was assessed by looking at what measures are necessary in order to achieve the stated objectives, also taking into account the magnitude of the underlying problem.

[86] See https://ec.europa.eu/commission/index_en.

Table 9: Summary of options and their effects

	Options			
Criteria	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	+	+++	++

All the policy options are expected to improve the situation over the baseline, even if their degree of effectiveness can only be estimated. In particular, the lower effectiveness of option 1 against the stronger solutions (options 2 and 3) stems from the Member States coverage. The former would target material changes in a few Member States only while the latter would likely cause changes in most, if not all, Member States. On the flipside, targeting only the most material issues in a few Member States under option 1 would lead to lower need to adjust other legislation to maintain their preferred debtor protection rights, whereas option 3 would require Member States to adapt significantly national legislation. Box 1 below summarises the modelling work undertaken to quantify the magnitude of impacts of the different options in terms of increasing NPL sales. The details and quantification of other effects is provided in Annex 4 and 5, with evidence from the stakeholder consultation presented in Annex 2.

Though options 2 and 3 are more efficient in fostering a single market, i.e. increasing investor base and firms active as loan servicers, than the non-binding option 1, it could take more time before they are effective. Common principles could be implemented particularly quickly in Member States if they accompanied the set-up of an asset management company (AMC) that collected NPLs from banks, outsourced their interim management to third-party loan servicers and conducted auctions to ultimately sell them to non-banks. In this case, principles could be introduced in form of eligibility rules for loan servicers and participants in NPL auctions rather than through legislation.

A relevant trade-off emerges in the choice between options 2 and 3 due to their legislative instrument, in terms of speed of enactment and effectiveness. A Regulation can be considered superior in securing harmonised market conditions and uniform conduct of participants across Member States. Whereas a Directive would allow Member States to reflect country-specific conditions and preferences in their implementation and a Regulation does not, the Directives' additional degree of freedom may also lead to gold plating and reduce effectiveness.

Trade-offs can also emerge between the opening up of competition to foreign entities and the effectiveness of national safeguards for borrower rights. Borrowers' rights do not change with the transfer of loans and, subject to applicable civil law, the borrower can use against the new owner the same defence available against the original creditor. However, the borrower is exposed to higher uncertainty because he/she is facing a new counterpart and starts from a weak bargaining position since he/she has not delivered on contractual obligations beforehand. Since the counterpart is located in a different Member State, the borrower may not know it and not understand how it is regulated. At the same time, opening access to foreign competitors appears essential to stimulate competition on NPL markets.

Options 2 and 3 score better on coherence than option 1, since there is a risk that the common principles will neither achieve a more resilient financial sector, nor will they lead to more homogeneity across the CMU. The scope of options 2 and 3 to accomplish these overarching objectives is comparable.

Option 1 may not be able to solve the issue of high NPL in some Member States and is therefore considered the least proportional, despite yielding some improvement over the baseline. Option 3 is more intrusive on Member States' sovereignty and existing legislative framework, and therefore less proportional than option 2. While Table 11 suggests a clear ranking of the different options in terms of proportionality, this is based on the assumption that reducing NPL is possible and risks for borrowers can be contained by adequate accompanying policies and Member States are prepared to take the costs of these accompanying policies. The ultimate choice will need to depend on the weight given by political preferences to the trade-off between engineering the most efficient or effective option on the one hand and the risk to borrowers and the costs to contain these risks on the other hand.

Overall, the comparison of the effects of the different policy options is inconclusive as regards whether option 2 or 3 is superior. The former has a somewhat lower effectiveness but with a better proportionality, while the reverse is true for the latter. The ultimate choice will depend also on policy preferences. The key question is whether the priority is to opt for a measure that is most effective, or for a measure that maintains more room for national discretion or minimises the scope of policy intervention to the most urgent challenges.

Box 1: Quantifying the impact of the different policy options

In order to compare the impact of the different policy options in a quantitative way, different scenarios were imputed on the pricing model presented in Annex 4.3. The simulation results are depending on a number of simplifying assumptions and could be different if better data was available. The model and main results can be summarised as follows.

A larger investor base and more competition among investors for NPL portfolios should impact investors' return requirements. In the pricing model, the expected return consists of a fixed amount and a country-specific risk premium. For the former 15% is assumed, for the latter is the lending rate to non-financial corporations is taken. The sum of both is a bit higher than realised returns in investment funds (see Annex 5.1)[87], but broadly consistent with those of investment firms that provide loan servicing (see Annex 5.2).[88] The country-specific risk premium is approximated by the lending rate to the non-financial corporate sector (DK, AT and SE). The benchmark is defined as average profit margin in the three Member States with the lowest lending rates.[89]

For the simulation of the impact of common principles, return requirements decline in a group of Member States and for the sample the group was chosen to consist of BG, EL, IT, CY, HU, AT, PL and RO. In these Member States, it is assumed the difference between the country-specific risk

87 The median of the internal rate of return of investment funds in the data panel is 12%.

88 The average profit margin of the firms listed in Annex 5.2 Table A3 is 17%.

89 Lending rates were equally small or smaller in LU and MT, but not considered a good benchmark for this exercise because of the small size of lending markets in these two Member States.

premium and those of the benchmark declines by a third. For the quantification of the effect of passporting, it is assumed that higher competition from a larger and more mobile investor basis leads to a decline of the internal rate of return by 0.5 %pts. This is about the difference between rates of returns of investments in distressed debt in Europe and North America (see Annex 5.1). To reflect that Member States with high country risk may benefit over-proportionally, the scenario also includes that half of the gap between the Member State and the benchmark is closed. In countries with a negative spread, this convergence effect does not materialise.

As regards loan servicers, the common principle scenario assumes a decline in indirect costs of loan servicing by 10% in DE, EL, IT, CY, and AT. For the scenario of passporting, it is assumed that the possibility to realise scale effects reduces indirect costs by 10%. Since Member States with high entry barriers are supposed to benefit over-proportionally from the passporting regime, it is furthermore assumed that half of the gap in indirect gap to the benchmark is closed. The defined benchmark is the median of all Member States, i.e. indirect costs of 9%. This second effect is not applied to Member States with indirect costs lower than the benchmark. For the single rule book, the scenario is similar to those with the passport regime. It is assumed that the possibility to realise scale effects reduces indirect costs by 10% and that half of the gap in indirect costs to the benchmark is closed. This effect applies also to Member States with indirect costs lower than the benchmark, i.e. costs in these Member States would increase. The impact is assumed to be asymmetric, the gap closes by a quarter for those Member States with initial indirect costs below the median and by a half or those above the median.

The Table below shows the simulated impact of the scenarios on NPL sales using the model-based changes in the bid-ask spread (Annex 4.3) and translating the effect of a declining bid-ask spread on NPL sales using the coefficients derived in Annex 4.2 (See Annex 4.3 for more details). The estimation suggests that NPL sales could increase from a level of currently about EUR 100 billion to 103-115 each year. The incremental contribution to the reduction in the NPL ratio will be marginal at EU level. On a few Member States with high NPL ratios, the impact on the NPL ratio would be significant, even as a stand-alone measure.

If combined with the implementation of policy measures, the existence of better functioning secondary markets for NPLs would also help reduce help NPL ratios in future crises. First estimates suggest that a more favourable insolvency framework with a 10% lower recovery time of NPLs leads to a further increase in loan sales by about 10%

Table: Simulation results: NPL sales in billion EUR on the EU and in selected Member States two years after the measure is in place

	Baseline	Scenario A: Common principles	Scenario B: Passport	Scenario C: Single rule book
NPL investors	100	102.2	109.4	109.4
Loan servicers	100	104.4	121.2	119.8
both combined	100	106.6	130.6	129.1
- memo: NPL ratio	3.1	3.1	3.0	3.0
Impact of combined measure (NPL investors and loan servicers) on selected Member States after two years				
Greece				
Loan sales	0	1.03	1.75	1.74
- memo: NPL ratio	46.5	46.1	45.8	45.8
Cyprus				
Loan sales	0	0.34	0.91	0.91
- memo: NPL ratio	42.7	42.1	41.0	41.0
Portugal				
Loan sales	2	2	2.8	2.8
- memo: NPL ratio	16.8	16.0	14.9	14.9
Italy				
Loan sales	54	58.9	71.4	71.4
- memo: NPL ratio	9.8	9.6	9.1	9.1

8. PREFERRED OPTIONS

The comparison of the effects of the different policy options shows that option 2 and 3 have different strengths in addressing different issues, and do not lead to clear conclusions as to a preferred option in terms of the selection criteria used in the assessment. It will therefore require political considerations to prioritise the choices, based on the impacts and trade-offs presented in the preceding sections.

A single rulebook Regulation that fully harmonises entry and conduct rules for investors and loan servicers would deliver an outcome closest to a single market. Such a single rule book is the most effective measure to increase the investor base for NPLs and reduce the currently high stock of NPLs in the EU and some of its Member States in particular, while ensuring a level playing field among firms from different Member States. It could imply however that certain national specificities cannot be taken into account, and that market entry could become more costly in those Member States in which market entry is already simple, and should be formulated such that it minimises the additional obstacles. Still, some Member States would be required to review whether enactment of a regulation that alters authorisation and conduct rules for NPL purchasers and loan servicers would lead to gaps in terms of borrower rights and data protection and would need to adjust other national laws accordingly.

Since a minimum standards Directive would allow Member States to maintain lighter regimes provided that they respect certain minimum conditions it might stimulate market entry more than a Regulation, depending on implementation in national laws. It could therefore be a good option in increasing the investor base for NPLs and competition on loan servicing markets while allowing Member States to maintain certain national specificities. At the same time it would be less effective in ensuring a level playing field and would give more discretion to Member States to goldplate the requirements, which would prevent these effects to materialise. Some Member States would need to adjust other national law if implementation of a Directive lead to gaps in terms of borrower rights and data protection.

The ultimate choice of the preferred option will depend on policy preferences and whether the priority is to opt for a measure that is most effective, or for a measure that maintains more room for national discretion or minimises the scope of policy intervention to the most urgent challenges.

Independent of the option chosen, the coverage of the initiative would be limited to introduce harmonised conditions for market entry and conduct of non-bank NPL purchasers and loan servicers.

- Loan servicers would need to fulfil fit and proper criteria with respect to their management, prove IT capacity and compliance with debtor and data protection obligations.
- A definition of loan servicing would clarify that loan servicers are not originating credit so that they do not require a banking license.
- Their relationship with the NPL investor/purchaser would need to be clarified and Member States should supervise them given the loan servicers' interaction with the ultimate debtor.
- Home and host supervisors would need to cooperate.
- Rules for NPL purchasers should be simple, possibly not going beyond registration and fulfilment of fit-and-proper criteria. Currently, non-bank investors do not face entry barriers in several Member States, while in others banking licences are required. If entry conditions for NPL purchasers would be left outside the scope of EU measures, the obstacles in other Member States would continue to exist.
- There would be no limitation on the type of loan non-banks are allowed to acquire: performing and non-performing and independent from type of borrower
- A possibility to cover NPL purchasers without putting additional administrative burden on them would be to offer an exemption from authorisation if they delegate the servicing of NPLs to an EU authorised loan servicing firm. If they decide to service loans themselves, they could be treated as loan servicers, possibly restricted to loans with consumers as borrowers.

Two important aspects would be outside the scope of the initiative:

- It would not strive to harmonise debtor protection rules across Member States. A reassurance of the borrowers' position may be is needed, in light of the many replies to the public consultation that flag debtor protection as a concern of more active secondary markets for NPLs. In any case, for all credits, additional safeguards should avoid that the harmonisation of authorisation conditions undermines borrower rights, including the need to impose the respect of the national rules, reinforced information to the borrowers about their rights and legal defences and the possibility to file complaints to national authorities.
- In view of the different legal traditions in Member States, standardisation of the legal tools available to transfer loans appears too challenging. Changing the fundamentals of the civil legal system does not seem proportionate to the underlying problem and it does not seem achievable politically within a reasonable

9. HOW WILL ACTUAL IMPACTS BE MONITORED AND EVALUATED?

The proposal is expected to follow normal implementation procedures. Ex-post evaluation of all new legislative measures is a top priority for the Commission. The Commission shall establish a programme for monitoring the outputs, results and impacts of this initiative one year after the legal instrument becomes effective. The monitoring programme shall set out the means by which the data and other necessary evidence will be collected.

In terms of indicators and sources that could be used during the evaluation the following monitoring indicators:

- NPL volumes and ratios: The relevant data is available from the ECB and from EBA for all Member States so it is possible to conduct analysis at country level and check, inter alia, whether Member States having hitherto high NPL ratios benefitted over-proportionally;
- Loan sales in all Member States: this data is not collected officially so data collection and reporting would rely on Commission services, information from supervisors and consultancy firms;
- Composition of the NPLs, in particular amounts of secured and non-secured consumer credits and home loans;
- New purchasers of NPLs, number of smaller banks and banks located in Member States with hitherto low loan sales: This data would also rely on Commission services' data gathering, information from supervisors and consultancy firms;
- Loan servicers authorised in all Member States and their cross-border activity: This will be sourced from national competent authorities;
- Debtors' complaints about misbehaviour of loan servicers signalled to national competent supervisors and supervisors' follow up. Special attention will be paid to complaints about misbehaviour of cross-border loan servicers and their follow-up by home and host supervisors;
- Supervisors' sanctions of non-compliance to NPL purchasers and loan servicers with respect to borrower rights and data protection.

An evaluation is envisaged 5 years after the implementation of the measure and according to the Commission's better regulation Guidelines. The objective of the evaluation will be to assess, among other things, how effective and efficient it has been in terms of achieving the objectives presented in this impact assessment and to decide whether new measures or amendments are needed. Member States shall provide the Commission with the information necessary for the preparation of that Report.

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ANNEX 1: PROCEDURAL INFORMATION

1. LEAD DG, DeCIDE PLANNING/CWP REFERENCES

Directorate-General for Financial Stability, Financial Services and Capital Markets Union.

The initiative is included in the Commission Work Programme 2018 as agenda planning item PLAN/2017/1121.

2. ORGANISATION AND TIMING

Work on the Impact Assessment started in July 2017 with the first meeting of the Steering group held on 2 October 2017, followed by three further meetings on 8 November and 4 December 2017 and 26 January 2018.

The Inter Service Steering Group was formed by representatives of the Directorates General Competition (COMP), European Political Strategy Centre (EPSC), Economic and Financial Affairs (ECFIN), Internal market, Industry, Entrepreneurship and SMEs (GROW), Justice (JUST), Communications Networks Content and Technology (CONNECT), Taxation and Customs Union (TAXUD), the Legal Service (LS) and the Secretariat General (SG).

3. CONSULTATION OF THE RSB

The draft report was sent to the Regulatory Scrutiny Board on 6 December 2017. The Regulatory Scrutiny Board delivered a negative opinion on 12 January 2018. A revised drat was sent to the Regulatory Scrutiny Board on 29 January 2018.

Changes introduced following the first opinion of the Regulatory Scrutiny Board

- A new introduction common to all three legislative initiatives on NPL was introduced. It explains the NPL issue in a wider context and elaborates on the linkages between the various initiatives in the NPL Action Plan in greater detail.
- Differences in borrower rights were introduced as problem drivers as well as discussions how they interact with changes in the authorisation regime for NPL investors and loan servicers. This was also taken up in the discussion on the general impact of the initiative.
- Specific objectives have been aligned with the assessment criteria.
- The concrete provisions were further specified, including a description of the range these provisions could take and a discussion of best practices and how they could be combined to a consistent regulatory regime.
- Assessment criteria for the policy options were made less abstract by connecting them to the desired impact on the main stakeholders.
- Possible adjustment needs in Member States are shown in the impact section.
- The evaluation of the impact of the different policy options was restructured and expanded.
- The presentation of the comparison of the impacts was simplified. The translation of detailed assessment criteria into rankings is described in a new annex 4.4.

- Coherence and proportionality were added as assessment criteria.
- The set of preferred options was narrowed and the link to concrete provisions this entails described in more detail.
- The evaluation framework was made consistent with that of the other two NPL legislative initiatives and indicators for monitoring progress were added.
- A table with information provided by Member States about their authorisation regime for NPL purchasers and loan servicers was added as appendix to Annex 6.

Changes introduced following the second opinion of the Regulatory Scrutiny Board

- Clarification of the coverage of performing and non-performing loans in the three options.
- Addition of new elements for reviewing the success of this initiative. The additional indicators cover effectiveness of supervision and compliance with borrower rights and data protection.

4. EVIDENCE, SOURCES AND QUALITY

This impact assessment is based primarily on stakeholder consultations, the study of the FSC subgroup on NPLs and background documents prepared for the FSC subgroup, studies by EU and international organisations[90] and additional desk research of the Commission services. More specifically, sources include:

- replies by stakeholder to the following consultations:
  - A public consultation on the inception impact assessment, 26 June 2017- 22 July 2017.[91]
  - Public consultation on the development of secondary markets for non-performing loans and distressed assets and protection of secured creditors from borrowers' default, 10 July to 20 October 2017 (closed on 27 October)[92]
  - A questionnaire to EU Member States 7 April to 1 June (last submission received 4 October 2017)
- Feedback from stakeholders and researchers through phone interviews and e-mail exchanges with stakeholders.
- Feedback from stakeholders through bilateral meetings between the Commission services and stakeholders.
- Simulations with the pricing model (see annex 4.3)
- Cross-country analysis (see annex 4.2)
- Analysis of annual accounts of individual firms active in the loan servicing market [and non-public data about compliance costs and their determinants from firms] (see annexes 5.2 and 3.2)
- Analysis of the performance of investment funds investing in distressed debt

[90] Most notably ECB, ESRB, EBA and IMF.
[91] https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2017-3137460_en
[92] https://ec.europa.eu/info/consultations/finance-2017-non-performing-loans_en

- statistics and data from various sources, including ECB, EBA, World Bank, ORBIS, Preqin.
- Market reports and dedicated studies by consultancy firms (Price Waterhouse Coopers, Deloitte, KPMG, Earnest and Young etc.);
- Analysis carried out for other projects in the European Commission,[93]
- academic (economic) literature (see List of References);

For a detailed description of the methodological approach, analytical methods, and limitations of the evidence underpinning this impact assessment, see annex 4.

93 Impact assessment on initiative cross-border distribution of investment funds, 2017; Chapter on NPL in the Bruegel study on monitoring capital flows, 2017, Study on the Cost of Compliance with Selected FSAP Measures by Europe Economis 2009.

ANNEX 2: STAKEHOLDER CONSULTATION

CONTEXT

A public consultation was launched on 10 July 2017 with end-date 20 October 2017. It combined questions on the subject of NPL secondary markets with questions on the Accelerated Loan Security, which was later re-labelled into Accelerated Collateral Enforcement..

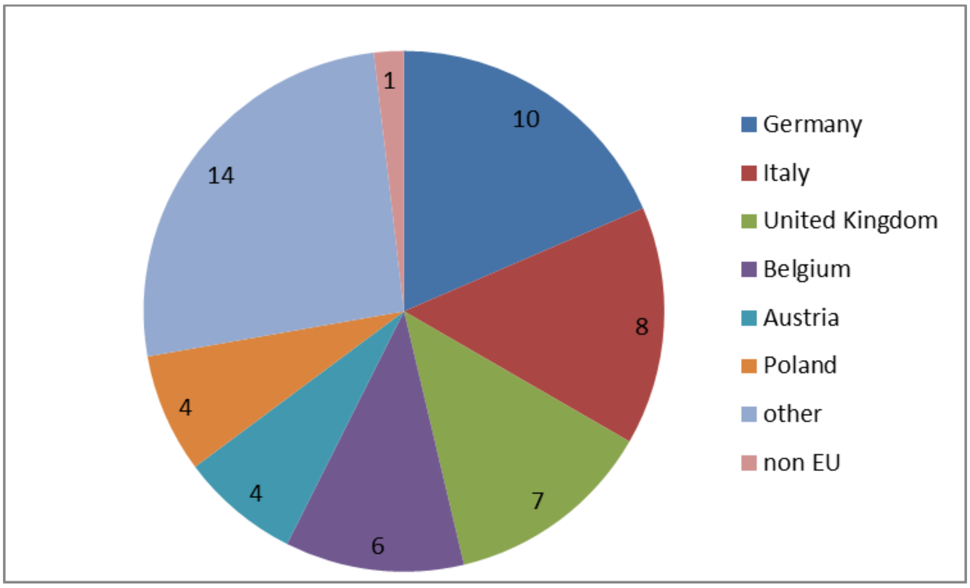
Since the public consultation asked stakeholders to identify obstacles to the development of secondary markets for NPLs and to give their view on their importance, several responses gave details on rules in place in the various Member States. Annex 6 focuses on this information, complementing the information received from a similar questionnaire sent to Member States.

1. COVERAGE AND REPRESENTATIVENESS OF THE CONSULTATION REPLIES

62 responses were submitted to the public consultation. However, some responses focused on the second part related to collateral enhancement and did not provide any input to the part on NPL secondary markets. Among the particularities were that several subsidiaries of one group sent submission, which were similar and consistent, but not identical. These were counted as one reply. Some associations sent almost identical replies. Since these represented standpoints of different institutions, each submission was taken individually. Overall, 51 submissions contained views about the development of the secondary market for NPLs. 10 of them declared that their submission should not be made public.

The Commission received replies to the consultation from respondents in 16 countries. Most submissions came from Germany (10) and Italy (8 of which 3 from citizens). There were also numerous contributions from the UK (7) and Belgium (6), accountable to the domiciliation of consultancy and law firms in the former and the seats of European organisations in the latter. 4 contributions came from each Austria and Poland. The only submission from a country outside the EU was from China.

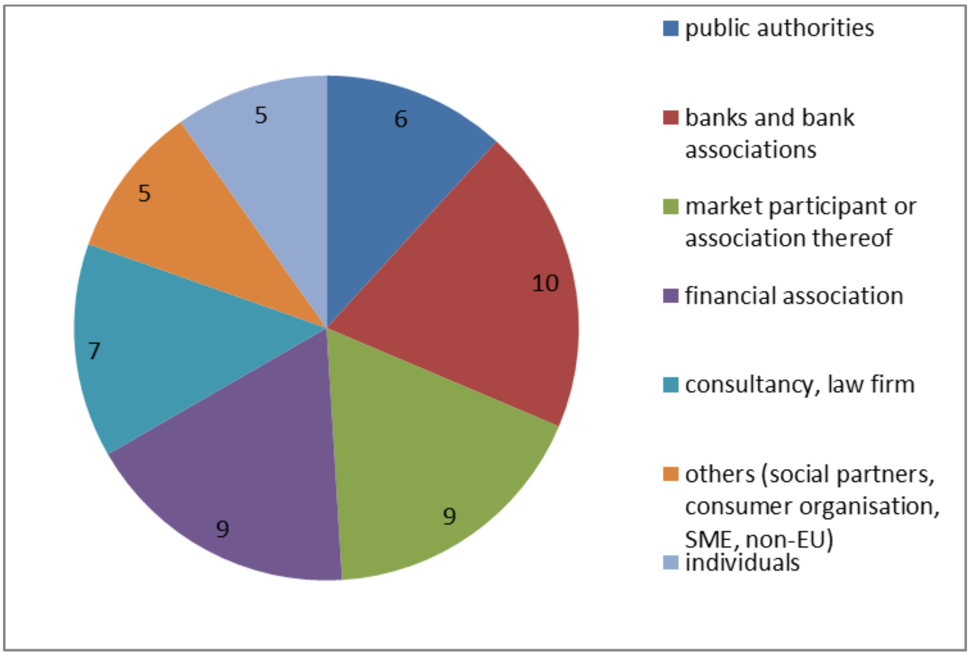
Figure A2.1: Number of respondents by Member State



Since the issue at hand has a single market dimension and since third-county investors have an important role in NPL markets, it is consistent that many submissions came from international actors. If international associations, cross-border firms and consultancy firms are counted as representing supranational interests, 29 submissions (57%) fall into this category and 22 would represent interests in a particular Member State. Although no submission came from US investors, those of consultancy and law firms may come close to representing views from third-country investors.

The type of respondents is mixed. 9 replies came from firms active on the demand side of the NPL market or associations thereof. Also 10 submissions came from banks or their associations, i.e. representing the supply side view of the NPL market. 8 submissions were received from other financial associations and 7 from law or consultancy firms. 6 public authorities replied and 5 citizens. The remaining submissions are attributable to social partners, consumer organisations and one SME.

Figure A2.2: Replies to the consultation by type of stakeholder



Submissions differed in character and granularity. Some replied directly to the questions, some added reasoning. The numbers and indications of frequency below relate to those replies where either a direct response was given or Commission staff was able to derive it directly from the text. In those cases, where this was not possible, the reply was not counted for the determination of relative weight of responses. While some responses could not be used to determine support or not for a specific question, the reasoning and background provided entered nevertheless into the qualitative assessment done in other parts of this impact assessment.

Given the small number of responses and their non-representativeness, all numbers can be taken as a tendency only. If it was possible to trace back differences in responses to characteristics of the stakeholders, this is indicated below.

2. The role of NPLs and NPL markets

The dominant majority of the replies affirms that the current size, liquidity and structure of secondary markets for NPL in the EU are an obstacle to the management and resolution of NPLs in the EU. Some even describe this obstacle as significant. It is, however, notable that 13 submissions (25%) disagree and among them are some firms active in the market or their associations. Some argue that markets work efficiently at national level, others that the market will develop.

Question 1: Would you consider the current size, liquidity and structure of secondary markets for NPL in the EU an obstacle to the management and resolution of NPLs in the EU?

	yes, a significant one	yes	no	No reply
Number of responses	11	10	13	17
in %	21.6	19.6	25.5	33.3
in % of those that replied	32.4	29.4	38.2	

According to respondents, internal and external factors are relevant for banks to decide whether loan sales should be a significant part of their strategy to manage NPLs. None of the responses said that external factors alone are relevant. Among the internal factors, the impact of NPL sales on banks' capital and provisioning, including tax rules on provisioning, and the role of supervisors are often mentioned, the administrative costs of internal work out is also frequently listed. A few replies also refer to reputational risks. Examples for external factors were given less frequently and often of general nature, suggesting that the existence of an efficient secondary market and fair prices would be beneficial for banks.

Only few submissions make a point on whether the lack of investors is an obstacle to market development and among those that do, a slight majority rejects the notion. More specifically, most submissions from actors on the demand side of the market do not address the specific issue, while most of those from banks and bank association, representing the supply side affirm that the lack of investors is an obstacle. Most submissions consider specialisation advantages and management capacity as the economic benefits of non-bank investors, followed in frequency by non-bank's general contribution to help offloading their high NPL level. Occasionally, it was also said that the involvement of non-bank investors could improve the recovery value of NPLs or that benefits are due to non-bank investors longer time horizon.

3. Measures targeting NPL investors

As regards obstacles for investors to enter the market, data and information issues are by far the most frequent reply. Second ranked are non-financial factors, often specified as taxation or IT issues, closely followed in terms of frequency by legal conditions/insolvency law and banks' behaviour. Some replies also indicate other financial factors as obstacles and give as example the link of NPL to securitisation markets.

Several stakeholders also list risks and concerns from the involvement of non-bank investors. These concerns are diverse and cluster around the issues of reputational risks and consumer protection, a possible information disadvantage over banks including as regards local knowledge, a shift of losses from the regulated banking sector to unregulated entities, the impact of investors' short time horizons and high return requirements in the non-bank financial sphere.

The frequency with which main benefits and risks of NPL markets were indicated can be taken as approximation of their importance. The benefits most frequently listed relate to scale and liquidity on a deep and large market, and to specialisation gains. As regards risks, consumer/debtor protection and data protection and privacy are very frequently indicated; less often did respondents see risks from moral hazard. There are also several references to the equal treatment of investors and the efficiency of the legal framework, which do not fall into a risk/benefit categorisation.

For a clear majority of those respondents that give a view, differences in national rules pertaining to NPL sales are an obstacle to the development of NPL markets. This view is shared among firms active on the demand side of the market and other stakeholders. The opposite view is held by 37% of those respondents that reply to this question. Those that give reasoning argue that either there are no significant obstacles or that the different legislative frameworks or economic developments justify the differences.

Question 9: Are national differences justified?

	yes	yes with reasoning	no	no with reasoning	No reply
Number of responses	7	13	11	3	17
in %	13.7	25.5	21.6	5.9	33.3
in % of those that replied	20.6	38.2	32.4	8.8	

Question 10: Are national differences an obstacle?

	yes	yes, with reasoning	no	no, with reasoning	No reply
Number of responses	7	10	5	5	24
in %	13.7	19.6	9.8	9.8	47.1
in % of those that replied	25.9	37.0	18.5	18.5	

As regards the nature of obstacles for cross-border activity, the dominant number of responses refers to the legal framework, insolvency rules and local habits. Much fewer respondents regard data issues or incentive problems as underlying drivers. When asked whether differences in these benefits and risks across Member States justify national differences in the framework for the secondary markets for loans, the majority agrees. Among those that consider national rules an obstacle, 40% finds them justified while 60% do not.

Some stakeholders hold necessary additional rules to safeguard consumer/debtor protection while others that think current rules are existent and should be maintained. The number of both views is broadly equal. A non-negligible number advocates specific rules for banks, non-bank investors and debt collection firms. Statements on the need to improve or maintain data protection level are not frequent, but generally affirmative.

Question 14: Do you consider that an EU regulatory framework (Directive or Regulation) regulating certain aspects of the transfer of loans would be useful?

	no	yes	conditional yes	No reply
Number of responses	11	15	11	14
in %	21.6	29.4	21.6	27.5
in % of those that replied	29.7	40.5	29.7	

While a majority supports an EU framework for NPLs, the minority share is sizeable and it is not possible to attribute a specific characteristic to this minority. For example, while the few individual firms on the demand side of the market are supportive to an EU framework, three associations related to demand side of the market are not. Banks and their associations, representing the supply side of the NPL market are also split. The dissenting minority consists of national actors and those with a supranational perspective. While most dissenting respondents are located in a Member State with a low NPL ratio, some respondents from these Member States supported an EU framework. It is also notable that among those that support an NPL framework at EU level, some make this conditional on a good design that is not overburdening the market players, takes local determinants appropriately into account and is targeted to obstacles and disincentives.

The consultation replies reveal a broad range of issues an EU framework for NPL sales should cover. In order of frequency in which issues were mentioned: The link of such a framework to insolvency law and debtor protection is very frequently flagged. Several responses advocate measures to standardise the legal process of loan transfers. Some submissions propose measures to facilitate data transfer and data management. The request for licensing of NPL sellers appears in the replies at comparable frequency. A few replies also make a link to taxation and banks' capital requirements.

4. THE ECONOMIC FUNCTION OF LOAN SERVICERS

Many respondents recognise advantages from the use of third-party loan servicers and considers them as important for the functioning of NPL markets. The dissenting minority refers to a lack of evidence and argues that internal work out in banks can be as effective as the outsourcing to loan servicing firms.

Respondents to the consultation see the role of loan servicers largely in managing NPLs, some consider they manage both performing and non-performing loans, and very few also attribute a role to them in securitisation and specialisation in real-estate loans. Many describe as valuable their services linked to monitoring, evaluation and information. Very few make a similar point with respect to other objectives such as the accomplishment of lower costs of the management or a higher recovery value of the NPLs.

Question 16: What are the advantages of having access to third-party loan servicers in terms of secondary loan market efficiency?	
yes,there are advantages.	20
loan servicers, debt collection important for NPL market/investors	17
advantages from specialisation	19
advantages from scale effects	10
other	8
no advantages	5

Almost all stakeholders that see advantages flag benefits from specialisation. Some submissions argue that benefits derive also from scale effects, local expertise and expertise in collateral management or help with restructuring debt. A few argue that loan servicers can help NPL investors in their bargaining process with banks, while a few others argue that the realisation of advantage is depending on the nature of the outsourcing firm. Points made in this respect by some respondents are that outsourcing to third-party loan servicers creates new risks, potential conflicts of interests and impacts the reputation of the outsourcing firm. The impact of outsourcing on debtor and data protection is also regularly listed in this context.

Stakeholders' views are almost equally divided on whether there are obstacles for banks or non-bank investors to access third-party loan servicers or not. Several responses affirm that country-differences matter. One respondent remarks that absence of loan servicers would have no impact on NPL transactions taking place. Another one sees advantages from ownership of loan servicers, while a third considers it a disadvantage if loan servicers were owned by competitors on the NPL market.

As regards the impact on the ultimate debtor of an involvement of third-party loan servicers, a clear majority considers that it represents a challenge to existing debtor protection rights. While those that see no risk for debtors or consider existing rules as sufficient are a minority, some of them make the case that the obligations of the debtor do not change if a loan servicer becomes involved. Others explicitly refer to the reputation of loan servicers as a challenging factor.

5. POLICY MEASURES TARGETING LOAN SERVICERS

A clear majority considers differences in business practices in loan servicing as significant. Views are almost equally split on whether the differences are justified or caused by financial regulation. Among those that do not consider them significant are also firms active in the market and one respondent argues that market entry of international firms has led to a convergence of industry practices regardless of the local market. As regards activity in several jurisdictions, relevant differences are seen as caused by legal tradition and consumer protection rules. Several respondents flag the difficulty and costs to learn and adjust to local conditions and some stress also the relevance of differences in licensing rules in this respect.

A substantial majority of responses indicates that it would be warranted to remove these obstacles and that this would have a positive impact on NPL markets. The few dissenting comments argue that consumer legislation requires differences across Member States to be maintained or that it could have a harmful impact on lending markets.

Question 23: Do you consider that a EU regulatory framework (Directive or Regulation) regulating third-party loan servicers would be useful?

	no	yes	no reply
Number of responses	7	28	16
in %	13.7	54.9	31.4
in % of those that replied	20	80	

A substantial majority supports an EU framework for loan servicers. Only a small minority either objects or abstains and among them also respondents active in the market or representing interest of market participants. Almost all respondents that support an EU framework advocate it should cover a licensing regime and about half of them propose it regulates the supervision of loan servicers. Several also advocate measures to access data and improve data transparency. Many mention taxation, debtor protection and insolvency law as framework conditions which, if harmonised, would also improve conditions for international loan servicing firms. A few responses say that market standards and simplification should be covered. Single stakeholders also add as warranted coverage of loan servicers' remuneration structures, qualification requirements for their managers and staff, respect for local rules, debt collection guidelines and suspension rules.

If yes, what should such legal framework include
(multiple replies possible)

	supervision of entities	licensing rules	simplification and standardisation	other	No reply
Number of responses	13	27	5	10	21
in %	17.1	35.5	6.6	13.2	27.6

Question 28: What specific aspects could be improved, in order to facilitate existing cross-border activities and/or entry into new markets?

	Number of responses	in %
Licensing, regulation and supervision of loan servicers	18	58.1
Access to data, transparency	14	45.2
Debtor protection	5	16.1
Insolvency law, bankruptcy procedures	9	29.0
Market standards	5	16.1
Taxation	13	41.9
Measures that target banks	2	6.5
Number of respondents to this question	31	60.8% of total

ANNEX 3: WHO IS AFFECTED AND HOW?

1. PRACTICAL IMPLICATIONS OF THE INITIATIVE

Investment funds and investment firms that intend to purchase NPLs from banks should face reduced costs in getting authorisation if needed and lower compliance costs when buying NPL from banks in different EU jurisdictions. This is particularly the case for the smaller funds and investment funds where compliance costs are disproportionately larger. Investors would also benefit from availability of more loan servicers and lower costs of outsourcing the management to NPLs to loan servicers caused by higher competition on the loan servicing market. Higher competition among NPL investors should lead to declining profit margins in this industry.

Loan servicers, debt collection firms and financial firms considering to enter this business line should face reduced costs in getting authorisation and lower compliance costs when managing NPLs outsourced from NPL investors to them. Firms acting in different jurisdictions would benefit particularly from the passport, which eliminates to request authorisation in each jurisdiction. Tapping markets in different jurisdictions allows them to realise scale economies. More competition among loan servicers and scale economies should lead to declining fees for loan servicing. Average size and market concentration is expected to rise while profit margins should decline in the medium term as the result of more contestable loan servicing markets.

Banks would face a larger investment base and the more intense competition among investors would lead to higher bid prices for NPLs. This increases their profits respectively reduces the loss they would derive from selling NPL portfolios to non-banks. Banks located in Member States with hitherto high entry barriers for NPL investors and a small investor base would benefit over-proportionally. Smaller banks would have proportionally larger benefits because the larger the investor base, the smaller the size of the average investor and the smaller the investor the more likely it is that they bid for smaller NPL portfolios held in smaller banks.

Institutional investors such as insurance companies or pension funds are unlikely to be enticed to enter NPL markets. They are offered a greater range of attractive investment opportunities in investment funds that buy NPLs as a result of the initiative.

Third country firms would face lower entry costs from licensing if they buy NPLs from EU banks or provide loan servicing to NPL investors. The passport offers them to conduct business in all EU Member States.

Consultancy firms and law firms may see part of their business and profit opportunities erode since potential market entrance will require fewer services and legal advice from them in an environment of less burdensome and more harmonised entry and business conditions.

Debtors should in the first place not be affected because their obligation to pay back their debt and interest is independent from whether the NPL is held by a bank or transferred to a non-bank. However, they may face welfare losses from uncertainty because facing a counterpart they had not chosen and do not know, especially if the counterpart is authorised in a different Member State. While they know the conduct of banks from past relationships, they have less certainty about how the new creditor or loan servicer will behave. Debtors may see a loss in value of their customer relationship with their bank if the bank decides to sell its loan to a non-bank. This could in turn increase the incentive of the debtor to avoid the loan becoming non-performing. There is also a possibility that if NPL markets are established, debtors attribute a smaller value to their customer relationship with their bank. This may have an impact on their selection of banks and conceivably also on their willingness to take a bank credit.

The potential impact on **highly indebted households** is hard to foresee as it will depend on the behaviour of loan servicers. If the latter help indebted social groups more than banks to arrive at a more suitable payback profile of their loans, debtors may benefit. The opposite is possible if loan servicers apply existing debtor protection rights in a stricter way than banks.

The enhanced environment for banks to offload NPLs from their balance sheets through loan sales should be positive for **SMEs** since it will create room for banks to expand lending to viable companies. Similar the impact on highly indebted households, the impact on highly indebted SMES will depend on the behaviour of loan servicers. If the latter help them more than banks to arrive at a more suitable payback profile of their loans, they may benefit. The opposite is possible if loan servicers apply existing debtor protection rights in a stricter way than banks.

The **public sector** benefits from lower NPL on banks' balance sheets. This reduces the fiscal costs of a banking crisis. It also reduced the costs of banking supervision because one critical element of supervision becomes less sizeable. The targeted reduction of compliance costs could reduce administrative burden for the public sector. Some Member States may face rising demand for authorisation from third-country firms that intend to make use of the passport, but may need to be authorised by the supervisor in one Member State for doing so. Unless the fees charged for authorisation and supervision contain an implicit subsidy for the applicant, the impact should be budget neutral even in those Member States facing an increase in requests. If Member States see their preferred state of debtor protection eroded through the EU framework for NPL investors and loan servicers, they would warrant to complement the policy options at EU level through policy measures at national level in a way that keeps their preferences in place whilst help develop the NPL secondary market.

2. SUMMARY OF COSTS AND BENEFITS

The heterogeneity of the conditions for market entry among Member States, as well as national supervisory requirements related to the size and legal form of any market participant considering to buy NPLs, complicate to a great extent the quantification of the benefits of changes to regulatory standards. Since most investors are hedge funds or private equity investors, regulatory fees in the asset management industry seem useful to serve as comparison term. If a NPL investor can operate under the regulatory regime of an investment fund, the regulatory start-up costs would range between about EUR 10,000 to about EUR 15,000.[94] A Commission study suggests that direct regulatory fees could amount to less than 20% and about 40% of the regulatory start up costs might be attributable to compliance costs in terms of labour costs and to pay external servicers for local facilities in the host country. [95] Annual ongoing costs, for supervision, were estimated at about the same amount. Since market sources interviewed by the Commission assessed the average of total costs to enter a new NPL market at about EUR 60,000 to 100,000, compliance costs are deemed not particularly high in relation with total entry costs incurred by investment firms.

Table A.3.1: Compliance costs of cross-border asset management firms

Type of cost	One-off (per fund and host jurisdiction)	Ongoing (per fund and host jurisdiction)
Compliance costs: external (legal) services for determining: • **marketing requirements** • **administrative requirements** • **notification requirements** • **regulatory fees**	Scenario A : €4,297 Scenario B: €8,150	Scenario A: €1,146 Scenario B: €6,983
Compliance costs: external services for local facilities	€ 4,930	€ 4,930
Charges: regulatory fees	€ 1819	€ 2194
TOTAL per fund	Scenario A: €11,046 Scenario B: €14,899	Scenario A: €8,270 Scenario B: €14,107

Note: Scenario A describes an asset management company relying on in-house legal advice and in-house fund administration, whereas Scenario B shows an asset management company outsourcing legal advice and fund administration to third parties.

Source: European Commission 2017.

Loan servicers are subject to costs for licensing in most Member States, with requirements and compliance costs differing across Member States. The NPL report of the ESRB (2017)

[94] European Commission (2017), Impact Assessment: Initiative cross-border distribution of investment funds.
[95] European Commission (2017), Impact Assessment: Initiative cross-border distribution of investment funds.

refers to market entry costs ranking up to about EUR 5 to 15 million, but does not specify the share of licensing costs or country differences. Market sources having replied to European Commission's inquiries indicate that licensing fees vary strongly across Member States and differences across firms in the same country suggest that both firm- and country specific factors matter.

From a very limited sample of replies, it became evident that actual one-off fees for the licensing vary from a few hundred euro (in several Member States such as Finland, Ireland, Sweden) to more than EUR 50,000 (for example in Czech Republic and Italy). Annual licencing fees range significantly as well, from a few hundred euro per annum to about 34,000 annual fees (for supervision of loan servicers charged in IE). Compliance costs for data reporting could add to these set-up and licencing fees the costs to comply with anti-money laundering rules, that may prove significant.

While fees for a banking license may not be particularly high, especially in those Member States that do not require a full banking license, a banking license carries additional compliance costs in terms of direct labour costs, necessary to ensure compliance with all rules applicable to credit institutions, including capital costs to fulfil minimum capital requirements.[96] In the absence of available examples for EU banking sectors, Dahl et al. (2016) in a US study on compliance costs found that small banks paid USD 100,000 to USD 170,000 for personnel expenses and USD 64,000 - 90,000 for other costs linked to compliance.[97]

According to market sources, some Member States' supervisory framework (for example Hungary and Romania) require a set-up social capital for loan servicers amounting to EUR 500,000 for NPLs acquisition and debt collection firms, respectively. Greece requires loan servicers to maintain capital of EUR 100,000. With a standard estimate of 10% costs for equity, this would translate into up to EUR 10-50,000 additional capital costs per annum if a banking license is required. Absolute amounts will be different for each individual case, also depending on the share of capital without a banking license. Similar considerations apply if NPL investors are required to set up a securitisation vehicle or investment fund structure and this needs to be supported with capital.

Cost structures relating to compliance depend strongly on the applicable legislation and type of firm. A 2009 study by Europe Economics[98] based its analysis of compliance costs

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96 Even in off-shore jurisdictions, setting up a credit institution would imply costs between $150,000 to $250,000, on top of more than $1 million in capital. See https://www.offshorecompany.com/banking/start-a-bank/your-own/

97 Costs for data processing, legal, accounting, and consulting. The numbers relate to community banks with total assets up to USD 250 million. See Dahl, Meyer, Clark Neely (2016) – NAME OF PAPER.

98 Europe Economics, 2009, "Study on the Cost of Compliance with Selected FSAP Measures", available on: http://ec.europa.eu/internal_market/finances/docs/actionplan/index/090707_cost_of_compliance_en.pdf

emerging from various EU Directives on extensive interviews with the financial industry. The results for the asset management industry are shown in the tables below. The one-off costs are not fully comparable to licensing costs since they relate to the investment costs of existing firms to comply with new regulation and not of new firms to comply with existing legislation. They may nevertheless be indicative of the types of costs involved.

Table A.3.2 The drivers of one-off compliance costs in the asset management industry by Directive

Directive	Prospectus	FCD	CRD	Transparency	MiFID	3AMLD
Familiarisation with Directive	6%	53%	5%	2%	6%	4%
Consultancy fees	30%	0%	19%	25%	16%	9%
Legal advice	21%	0%	0%	32%	4%	4%
Training	0%	2%	0%	0%	9%	17%
Staff recruitment costs	0%	0%	2%	0%	3%	3%
Investment/updating IT	24%	0%	62%	23%	48%	51%
Project management	19%	45%	11%	19%	14%	12%
Other	0%	0%	0%	0%	0%	0%

Note: FCD := Financial Conglomerate Directive, CRD := Capital Requirements Directive, MiFID := Markets in Financial Instruments Directive, 3AMLD := Third Anti-Money Laundering Directive
Source: Europe Economics 2009

Table A.3.3 The drivers of ongoing compliance costs in the asset management industry by Directive

Directive	Prospectus	FCD	CRD	Transparency	MiFID	3AMLD
Additional staff	50%	0%	25%	69%	20%	13%
Internal reporting	0%	3%	6%	0%	12%	3%
IT	50%	0%	13%	17%	28%	27%
External reporting	0%	97%	30%	1%	17%	14%
Training	0%	0%	11%	1%	7%	22%
Audit	0%	0%	15%	12%	16%	21%
Other	0%	0%	0%	0%	0%	0%

Note: FCD := Financial Conglomerate Directive, CRD := Capital Requirements Directive, MiFID := Markets in Financial Instruments Directive, 3AMLD := Third Anti-Money Laundering Directive
Source: Europe Economics 2009

Ongoing supervisory fees for banks depend, in the euro area, on the size of the bank and its risk exposure, by means of a fixed and a variable component. By means of example, a non-systemic bank with total assets of EUR 1.6 billion and risk exposure of EUR 700 million would have to pay a fee to the SSM of about 10,000 in 2017. In the chosen example, about a tenth of it is due to the fixed component.[99]

A recent study by Dahl et al (2016) decomposes the compliance costs of smaller US banks by cost type and size of bank. It demonstrates the importance of personnel expenses as well as strong scale economies underlying costs for personnel and data processing. Also the share of costs for accounting and consultancy decline with firm size.

[99] https://www.bankingsupervision.europa.eu/organisation/fees/calculator/html/index.en.html

Table A.3.4: Compliance costs in small US banks

2014 Mean Compliance Expenses

	Asset Size Categories				
	<$100M	$100M to $250M	$250M to $500M	$500M to $1B	$1B to $10B
Data Processing Expense	$27.6	$36.8	$82.0	$108.7	$188.3
	1.5%	0.9%	0.9%	0.6%	0.4%
Legal Expense	$4.6	$5.9	$20.0	$47.4	$134.9
	0.2%	0.1%	0.2%	0.2%	0.2%
Accounting Expense	$19.9	$31.6	$45.6	$57.7	$188.2
	1.1%	0.7%	0.5%	0.3%	0.3%
Consulting Expense	$11.7	$18.2	$24.0	$43.4	$129.1
	0.6%	0.4%	0.3%	0.2%	0.2%
Personnel Expense	$100	$176	$312	$507	$1,203
	5.3%	3.9%	3.4%	2.8%	1.8%
Total Expense	$163.8	$268.5	$483.6	$764.2	$1,843.5
	8.7%	5.9%	5.3%	4.2%	2.9%
Number of Banks	113	154	121	45	36

NOTES: The sample consists of 469 commercial banks with assets under $10 billion that responded to the Conference of State Bank Supervisors' survey in 2015 on operations in 2014 and for which complete data are available. Dollar amounts, expressed in thousands, represent means for banks in varying categories. Percentages are means within a category of the ratios of dollar amounts to overall noninterest expenses.

Cases of actual licensing costs are only available in form of anecdotal evidence. A market source indicated costs of EUR 60-100,000 to enter a market of which less then EUR 10,000 are caused to obtain a license as NPL investor. Market sources indicated a banking licenses in a Nordic country requires a guarantee depending on the turnover. It would amount to around EUR 500,000. A German bank founder reported to a newspaper costs of EUR 700,000 to EUR 800,000 to obtain a banking license in Germany.[100] Other online sources suggest that starting an offshore bank demands between $150,000 to $250,000 and requires $1 million in capital, depending on the jurisdiction. For founding a bank in the USA, the amounts would be four times as high.[101]

Cost savings would be very different across Member States depending on their licensing regime, which sometimes entails only a partial banking license. The table below categorises the examples given in the text below. Given the anecdotal character of some, their country-specific nature and different sources, they are not comparable.

Table A.3.5: Overview of administrative costs by type of financial institution

	Asset management	NPL investors	loan servicers	banking license
total costs	19,000-25,000	60- 100,000	50,000-15 million	USD 150,000-1,000,000
licensing costs	2000	10,000	6,000-80,000	500-800,000
annual fees for supervision	2000		34,000	10,000
labour costs, costs of outsourcing	5-15,000			
domicilation	5,000			

Note: all numbers in EUR unless otherwise indicated.

Box A.3: Cost savings potential from relaxed entry requirements

The actual cost savings by potential market entrants depend on the Member State concerned and more importantly on firm specific factors.

- In Member States where a licence is required for NPL investors, a different set of documents is often required and the exact requirements upon applicants and bureaucratic procedures vary, resulting in administrative costs and administrative delays (see Annex 6).
- Potential cost savings linked to lower fees for licensing and supervision seem to be less sizeable than labour costs and costs for legal advice and consultancy. In the related branch of the asset management industry, these administrative costs are at least twice as high as regulatory fees.

[100] https://www.welt.de/finanzen/article138894620/Das-aberwitzige-Abenteuer-eine-Bank-zu-gruenden.html
[101] https://www.offshorecompany.com/banking/start-a-bank/your-own/

- An important firm-specific factor is the size of the firm. Compliance costs rise under-proportionally with size, partially thanks to scale economies in processing data and to the fixed cost nature of consultancy costs.[102]
- Costs savings related to the fact of not requiring a banking license depend on both Member States' capital requirements and firms' optimal capital position. Member States differ in how much capital they require from a firm that buys NPLs or acts as loan servicer.[103] Notwithstanding the statutory capital requirement, many NPL investors and loan servicers voluntarily hold equity as capital. There are also NPL investors that voluntarily hold a banking license since it gives them the advantage of using the EU passport for expanding business to other EU jurisdictions.

The Table below translates the scarce information about costs that NPL investors and loan servicers entail if they expand activity into estimates of potential cost savings if any of the preferred option is implemented. Given the poor data quality, the numbers should only be seen as indicative. They will be very different in dependence of the individual firm. The numbers only cover regulatory charges. Labour costs and legal fees would multiply the amount.

I. Overview of Benefits (total for all provisions)		
Description	***possible cost saving per firm in EUR***	***Comments***
Direct benefits		
Lower entry costs for investors for NPL purchases in some Member States	500,000 if banking license was required previously	All options remove the need to request a banking license or set up a local entity for NPL investors
Lower costs for NPL investors to hold NPLs	50,000	All options remove the need to set up a securitisation vehicle or investment fund structure for NPL investors
Lower entry costs for EU loan servicers	500,000 if banking license was required previously	If the EU rule removes the need to request a banking license or set up a local entity.
Lower supervisory fees for EU loan servicers	10,000- 30,000	If the EU rule removes the need to be supervised in each Member State.
Lower costs for EU loan servicers to expand activity to other EU markets	6,000 -80,000 per market	If no further authorisation necessary to enter markets in other EU Member States. If the EU rule removes legal uncertainty from the absence of a uniform definition of loan servicing
Lower entry costs for third-party loan servicers	75,000	They can select one entry point to the EU market in accordance to their needs.
Larger choice for NPL investors to select loan servicers and lower costs for loan	#NA	The constraint from a limited number of local loan servicers is lifted. Loan servicers become more efficient

102 See the example of cost structures for compliance of smaller banks in the USA in the Table above.

103 Hungary and Romania request capital amounting to EUR 500,000 for both NPL acquisition and debt collection firms.

servicing		through competitive pressure and scale economies.
Indirect benefits		
higher bid prices for NPL portfolios	#NA	results from higher competition on NPL markets
larger transaction volume in NPLs	#NA	consequence of a larger investor base
Banks lower cost of NPL management	#NA	from the possibility to outsource to more efficient loan servicers
Banks to increase lending to the economy	#NA	As a result of fewer NPLs on their balance sheet
lower costs to securitisation with loans as underlying assets	#NA	As consequence of lower costs of loan servicing that spill over to the costs that securitisation vehicles will have to pay
lower risk to financial stability	#NA	from sounder banks with lower NPL ratios and reinforced consolidation in the banking sector

The required re-writing of law and its implementation will entail one-off costs at EU and national level, especially for Member States that used to ensure debtor protection through the authorisation and supervision of NPL investors and would need to implement new laws that uphold the desired level of debtor protection through other means. Costs of writing new legislation are substantial. Using data from New Zealand, Wilson et al. (2012) estimate costs of a new law to amount to USD 2.6 million USD and that of a regulation at about USD 400. They refer to a similar study that point at costs in the US amounting to less than USD 1 million, but find that this study is likely to underestimate costs. As negative outcome, one can assume that each EU Member State finds it necessary to adjust existing legislation and encounter costs as high as those found in the study from New Zealand. This would be broadly EUR 60 million[104] and may represent an upper bound because not all Member States would need to adjust national law and for those that do, it will concern most of the time adjustment of existing law rather than completely new law.

Some Member States may face rising demand or authorisation and licensing from NPL investors and/or loan servicers, which would imply higher administrative costs. Standard practice is that the public sector charges a fee for the licensing process and supervision that fully covers these costs. Recent work by the Commission services on the licensing of investment funds and crowdfunding (see corresponding impact assessments) identified licensing costs in the range EUR 5,000 to 10,000. One Member State calculates costs of supervision of a loan servicer at EUR 34,000. Given that supervision of loan servicers might be more expensive if the entity acts in different Member States, it would be reasonable to assume that costs increase up to EUR 50,000 p.a.. NPL investors may face lower supervisory costs if they use an EU supervised loan servicers. These costs could apply to each new entrant, but would need to be seen in conjunction with cost savings from a single point of

[104] 2,6 million times 28 Member States adjusted with an USD/EUR exchange rate of 1.2

entry rather than requiring to bear the costs for each Member State the entity wants to be active in.

II. Overview of costs						
	Citizens/Consumers/Business		NPL investors and loan servicers (per firm)		Public Administrations	
	One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Direct costs	none	none	for license EUR 5,000-10,000	for supervision EUR 10-50,000	creation of new legislation EUR 60 million	supervision of more NPL investors and loan servicers
Indirect costs	none	none	legal advice and labour costs #/N/A	maintaining It systems and storage of data #N/A	none	none

All policy options are expected to lead to compliance costs as regards the implementation of the new law, the relevant formalities and training for NPL investors and for loan servicers. Significant compliance costs are expected in particular when it comes to audit and management, monitoring, supervisory and licensing fees.

While the establishment of principles or rules at EU level would entail compliance costs, NPL investors and loan servicers would no longer be exposed to the costs of compliance to national rules. Overall, the EU compliance costs should be lower than the average compliance costs across EU Member States. Especially NPL investors and loan servicers operating in several EU Member States should benefit from lower compliance costs.

Given the fact that national rules for loan servicers are generally tighter as compared to national rules for NPL investors, compliance with common rules is likely to trigger higher costs for loan servicers as compared to NPL investors. Citizens/consumers are not expected to bear direct costs. Banks wishing to sell NPLs may be exposed to indirect costs resulting from the regulatory change if these affect the price bids of NPL investors.

In both groups of market players (i.e. NPL investors and loans servicers), the cost of complying with the regulatory change is expected to be greater for small players as compared to bigger players as those costs constitute a greater share in revenues. In the case of small NPL investors, this initial cost may be compensated over long term with greater revenues linked to expanded activity across country borders. The described compensation is less likely for loan servicers, whose operations are characterised by economies of scale. Consequently, the loan servicing sector is expected to consolidate following the regulatory change, with potentially negative effects for small businesses but with efficiency gains at an aggregate level.

Over longer term, i.e. once market participants have adjusted to the regulatory change, cost savings are expected for the industry on activities such as application for a licence, calculation of regulatory fees, regulatory reporting, marketing. A further beneficial impact on costs is expected thanks to a lesser need for legal advice due to harmonisation and transparency of rules..

For market participants based outside the EU in particular, NPL investors and for loan servicers are expected to benefit not only from lower regulatory fees but also the potential search and legal counsel costs, facilitating access to EU markets.

From consumer perspective, the obligation to respect national rules for privacy, data and debtor protection for loan servicers is key to ensure an adequate and predictable level of consumer protection in all EU countries.

ANNEX 4: ANALYTICAL METHODS

1. A STYLISED VIEW ON DEMAND AND SUPPLY OF THE NPL MARKET

The first part of this annex presents a conceptual framework to analyse the potential impact of policy measures on the demand for and supply of non-performing loans on secondary markets. To put the initiative analysed in this text into perspective, the appendix gives a schematic overview of the different NPL initiatives and of the specific failures they address, such as shortage of supply, lack of demand, information costs, valuation.

The presented framework is theoretical as data availability does not allow a derivation of full quantitative properties of demand, supply and of the market equilibrium. A further complication arises from the fact that non-performing loans are not a homogenous good, which is evidenced by different prices for secured (largely by real estate) and non-secured (largely consumer loans).[105] Finally, the structure of the NPL market is that of an oligopsony, with few large buyers conducting a small number of transactions.[106] Notwithstanding the mentioned difficulties, it seems possible to derive stylised characteristics of the NPL demand and supply function based on the incentives that investors (the demand side) and banks (the supply side) face.

The proposed framework considers a simplified model of the NPL market with a portfolio consisting of a large number of homogenous loans. Looking at the supply side, the higher the market price relative to the nominal value (the gross book value), the higher the volume of NPLs proposed for sale. One can also assume a price floor below which banks will not offer any NPLs. Determinants of this floor could be: i) a (non-negative) expected recovery value on the loan portfolio, and ii) the desire by a bank not to realise capital losses, which may arise if the market price is too much below the expected recovery value. Even if the debtor does not pay back his loan, the bank may anticipate that he pays back part of the loan and may therefore wish to keep the loan on its books. Banks may also refuse to sell NPLs if they esteem the customer relationship and hope for ongoing business with the debtor, which could become profitable again.[107]The mentioned mechanism may result in a price ceiling. Moreover, the offer price may reflect potential reputational costs for a bank linked to NPL sales and their negative impact on long-term relationships with its clients. Finally, strategic considerations may also determine the offer price. For example, the bank may anticipate that the bidder will try to exploit its weak bargaining position if it has a large pile of NPLs on its

105 Prices for secured (largely by real estate) and non-secured (largely consumer loans) are very different. Italian buyer BancaIFIS (2017) shows divergent price trends for secured and unsecured NPL transactions in Italy.

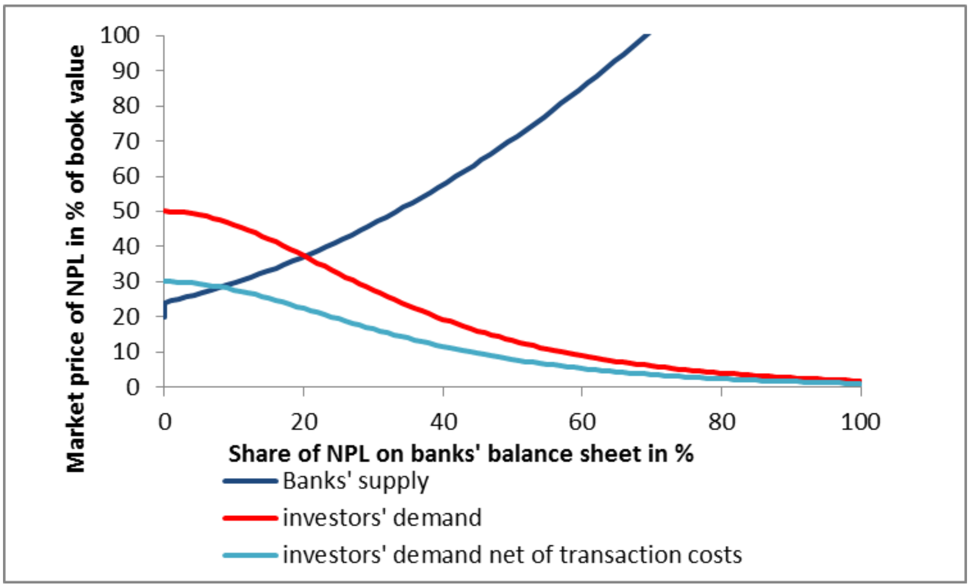
106 See Fell (2017).

107 Banks will have to decide when to keep the NPL on their books depending on the difference between the market price and the book value of a non-performing loan

balance sheet. Therefore, the bank may strategically decide to enter negotiations with a somewhat inflated offer price.

In the chart below we assume that at a market price equalling the nominal value banks will offer 70% of NPLs for sale (i.e. keep 30% of the NPLs on their loan book). We also assume that banks will not supply any NPLs to the market at a market price equal or lower less than 20% of the nominal value.

Figure A.4.1: A stylised perspective on demand for and supply of NPLs



Looking at the demand side, potential investors are expected not to offer a price much below the highest recovery value of the NPLs offered because it would be refused by banks. Although investors' expectations on recovery values may differ from related expectations by banks, the discrepancy may not be too significant. At the same time, investors are likely to demand a price that covers their costs of administering the NPLs, which may justify the discount as compared to the recovery value. NPL investors are also likely to request an add-on that reflects funding costs and/or their internal requested rate of return. Both seem to be higher for non-banks than for banks.

For a zero market price, demand for NPLs is expected to amount to the entire loan book as investors are willing to take the total loan book if it is for free. As to the shape of the demand curve, the relationship between price and demanded volumes is expected to be non-linear for strategic reasons. For smaller shares of NPLs offered, the investor may anticipate a lemon issue: the counterpart could offer NPLs with the weakest recovery value and keep the higher quality NPLs on the balance sheet. The described mechanism could in the extreme case lead to a demand curve which is backward bending in parts, i.e. demand declines when prices decline.[108] While it is not possible to identify the range in which the demand curve is backward bending, one can at least assume that the demand curve is steeper (i.e. more elastic to changes in prices) for lower volumes of NPLs. The larger the share of NPLs sold, the less relevant the lemon issue. For larger shares of NPLs offered, non-linearity may occur due to efficiency gains in loan administration, for example by realising scale effects in loan servicing and debt collection.

NPL transactions are done with consultants, which charge a price for their services. The added value of the consultancy services is to match demand and supply, which is not trivial given the opacity of the market, the underlying lemon issue and the bilateral bargaining position of both the buyer and the seller, requiring a tailor-made contract that encompasses all information and incentive asymmetries. These transaction costs are reflected in a bid-ask spread, which can be charged either on the selling banks or on the buying investors. The chart above assumes that the transaction costs increase the costs for investors proportional to the price and move the demand curve northwards.

Both the demand and the supply curve may be affected by policy options listed in the NPL action plan. More efficient insolvency frameworks would increase the recovery value of NPLs, thereby shifting both demand and supply upwards. Market prices would increase, but the effect on volumes is uncertain, depending on whether banks or non-bank debt collectors could benefit more from the improved insolvency framework. Another element potentially leading to a changed market outcome is supervisory pressure on banks to disclose NPLs and/or to off-load them from their balance sheet. If banks face stronger incentives to provision NPLs, the book value declines relative to the nominal value, which reduces the gap to the market price. The mentioned supervisory pressure has the potential to shift the supply curve downwards, thereby decreasing prices and increasing volumes. An establishment of AMCs could have a similar effect as it would incentivise banks to supply more NPLs if transactions are arranged by a third-party with possibly larger bargaining power and smaller stigma effects. The direct consequence could also be lower transaction costs if the AMC economises on some of the activity that consultants are undertaking.

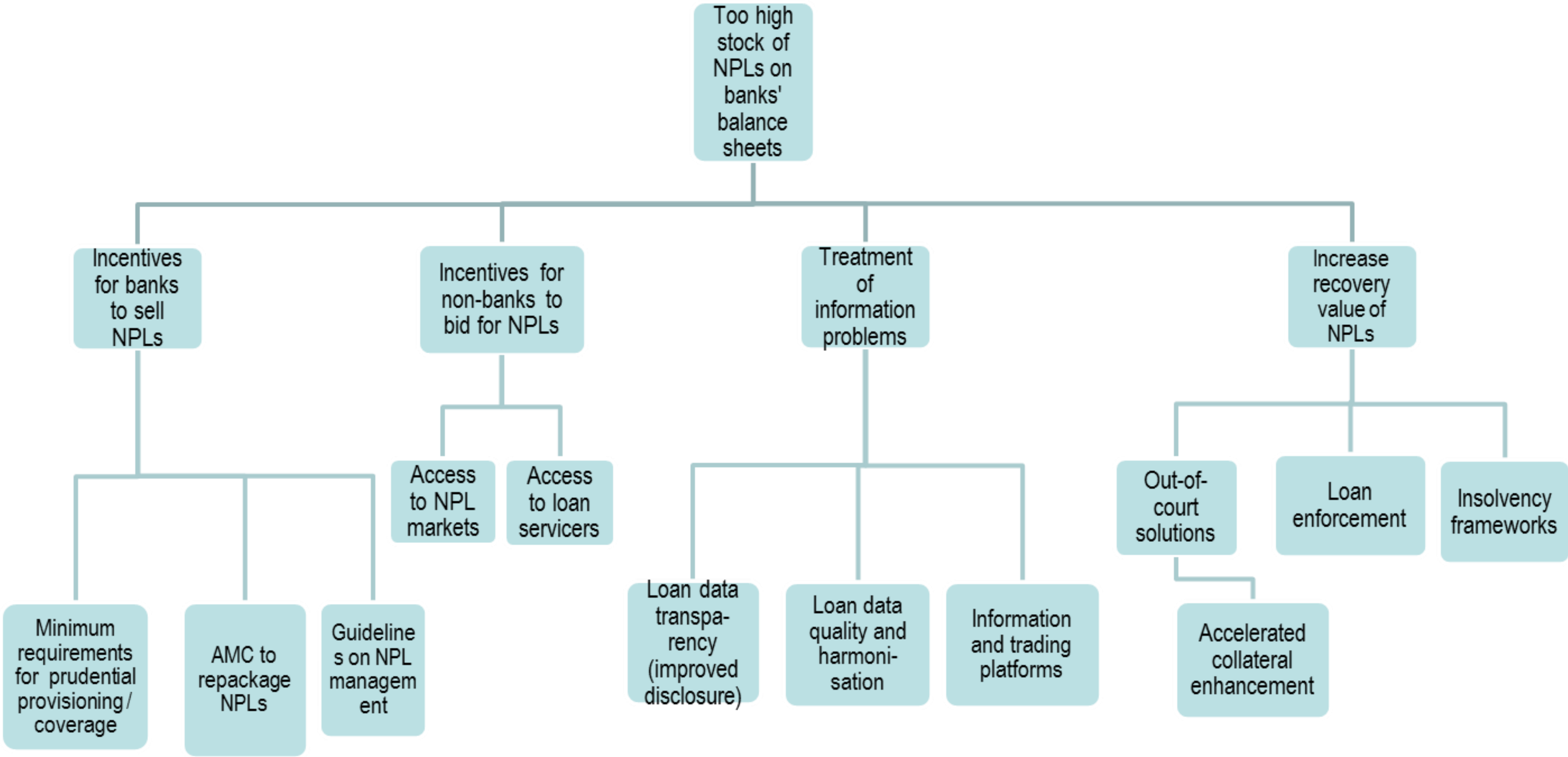
On the investor side, the existence of an AMC on the market would likely lower search costs but it could strengthen the bargaining position of their counterpart (i.e. the bank selling NPLs). AMCs and information platforms could also reduce transaction costs by providing impartial information to potential buyers, i.e. facilitating due diligence and reducing information asymmetries between the initial creditor and potential buyer of the debt contract. If the transaction costs are ultimately paid by the investor, the involvement of AMCs and information platforms will move the demand curve upwards, i.e. closer to the curve without transaction costs. More efficient securitisation markets would be largely to the benefit of

[108] This is depicted in a chart in the ECB Financial Stability report December 2016, p. 129. See also Fell (2017).

lower funding costs for NPL transactions, which could move the demand curve upwards as investors could afford to pay a higher price for NPLs.

Lowering market entry conditions for investors into the secondary market for NPLs would shift the demand curve to the right, but the impact on the reservation price is unclear as it is uncertain whether new entrants would be able to realise higher recovery values. Both recurrent and one-off costs may constitute market entry barriers as they affect the result of a cost-benefit analysis undertaken by a potential entrant. As to one-off costs, they cannot be recovered if the firm is not able to do successful business (so-called sunk costs) and they include: obtaining authorisation and licenses, investments to become eligible for national conditions, search for loan servicer. Examples of recurrent costs include: debt collection, collateral use, compliance to conduct rules.

Figure A. 4.2: An economic perspective on different policies to tackle NPLs in EU banks



2. CROSS COUNTRY ANALYSIS

This part derives insights from the cross-country variation in selected NPL data. The comparison covers the EU Member States. For some exercises, data was not avaialable for all EU Member States and in some comparisons it turns out that the UK observations were outliers. In some of the latter cases, the observations for the UK were not considered. Overall, the quality of the data basis is weak. Despite the weak data quality, most of the found correlation look plausible and evidence of a systematic bias in the data that would distort the results could not be detected. This said, the resulting numbers should be best understood as illustrative only as they do not stand up to the requirements of rigorous robustness checks.

The only official statistics available for NPLs are volumes of NPLs on banks' balance sheets and their ratio to loans and advances on banks' balance sheets collected by EBA and ECB. Since the coverage of banks is larger in the ECB than in the EBA data file, ECB data was used for the analysis.

The only source for data on NPL sales are international consultancy firms and they collect the data from public sources, own business and business contacts. Data collected and made public by the different consultancy firms is broadly similar, but differs somewhat, which indicates that the underlying ground work is difficult and there are limited means to verify data. Issues emerging from data quality are discussed below. For the analysis in this section, the data of NPL sale by Member State 2015 and 2016 published in PWC (2017) and Deloitte (2017). For ratios, the loan sales data of the year was combined with the stock of NPLs in the same Member State's banks' balance sheet at the end of the previous year, i.e. 2016 transactions relative to the stock in 2015Q4.

Even if consultancy firms strive to have a high standard on data collection, they do not have the means and authority to verify data to the same extent public statistical offices can. Hence, there may be a bias in the data emerging from the possibility that some loan sales take place without any notification to the public. Another issue is that the available data is patchy, i.e. not all data fields are complete. For example, the amount traded is not disclosed or available in more than 15% of the transactions, in one micro data set the Commission services were able to check. The consequence is that observations for Member States with few transactions and a large share of transactions with unknown amount cannot be used. This led to the decision not to consider the observations for Belgium in the analysis below.

Another complication for any empirical analysis with this data stems from the observations that underlying transactions are very different in size and a few very large transactions will determine observations for some Member States. This may cause outliers to have a strong impact on descriptive and analytical statistics. Since the largest transactions are clustered in Member States with a larger number of transactions (UK, IT, ES, DE, IE), the risk of empirical results being determined by individual loan sales appears limited.

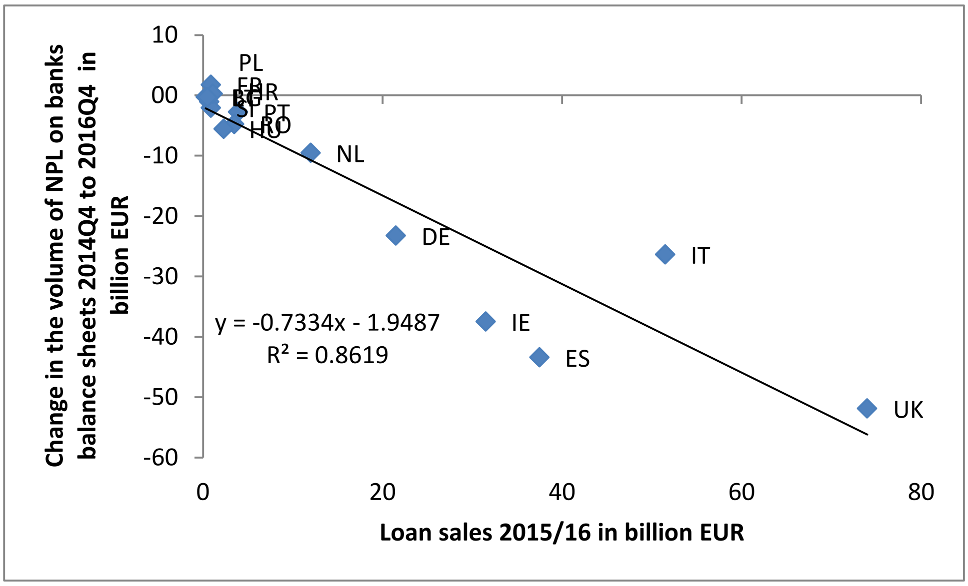
In almost 25% of the transactions, buyer respectively seller are not known. Hence it cannot be said whether the NPLs were sold or bought by non-banks or other banks. Very often loan sales combine the sale of non-performing with performing loans. Given the uncertain sourcing of the data, it may even be possible that some transactions are carried out with performing loans only. An example that combines several of these two issues is the sale of a portfolio with a face value of 11.8 billion GBP by UKAR to Prudential and Blackstone in May 2017.[109] The amount is equal to about 10% of the total annual turnover in 2016. The seller is not a bank, but a public AMC. The underlying 104,000 loans are performing and they had been originated by the bank Bradford and Bingley before it was put in public ownership in 2008.

While the share of NPLs in the reported loan sales is unknown, three different methods suggest it could be on average in the range of 70 to 80%.

- A first estimate stems from AFME and is reported in its reply to the public consultation. According to data from KPMG "74% of the total loans sales completed between 2015 and 1H 2017 in Europe represented either non-performing or a mixture of non-performing loans with other risk exposures (i.e. with performing, subprime, or re-performing loans)."
- A second estimate was conducted by the Commission Services with data from another consultancy firm shows a share of non-performing loans in loan transactions of 47% on average 2014-2016. It also reveals that for 34% of the loan amounts there is no information whether they are performing or non-performing and in 12% the loan amount was a mixed portfolio, consisting of a unknown share of performing and no- performing loans. If it is assumed that the ratio is the same in the unknown and mixed transactions as in the trades with a known breakdown, the ratio of non-performing loans in all loan trades would be 78%.
- A third method consists in a regression analysis that relates the loan sales in 15 EU Member States to the change in the volume of non-performing loans on banks' balance sheets (see chart below). The regression line suggests that for 100 billion EUR loan sales, the amount of non-performing loans declines on averge by 73 billion, i.e. an implied proportion of 73% of non-performing loans in total loan sales. If the outlying observation of the UK is not considered, the ratio would increase to 80%.

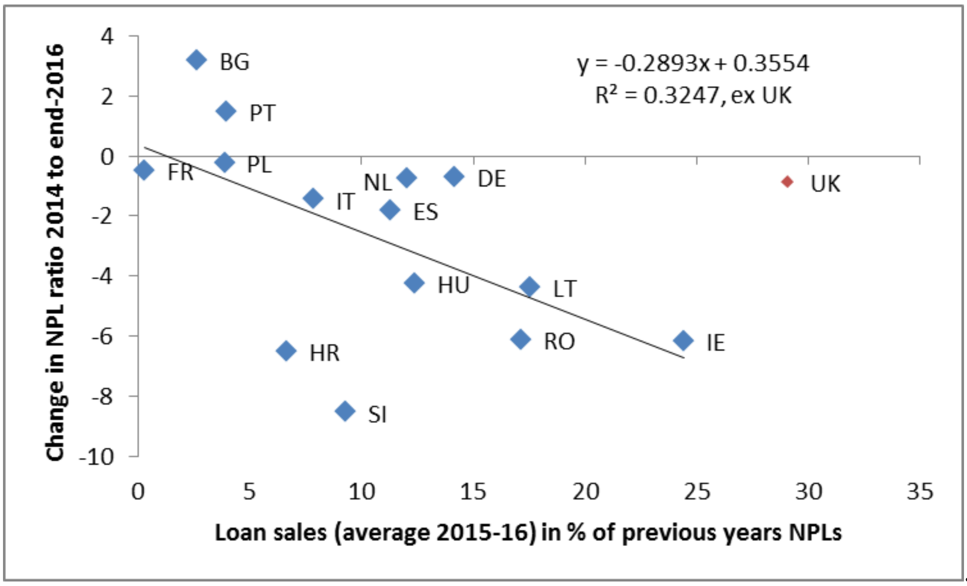
[109] See UKAR's press release of the deal at http://www.ukar.co.uk/media-centre/press-releases/2017/31-03-2017?page=4.

Figure A 4.3 Loan sales and change in NPL volumes across EU Member States



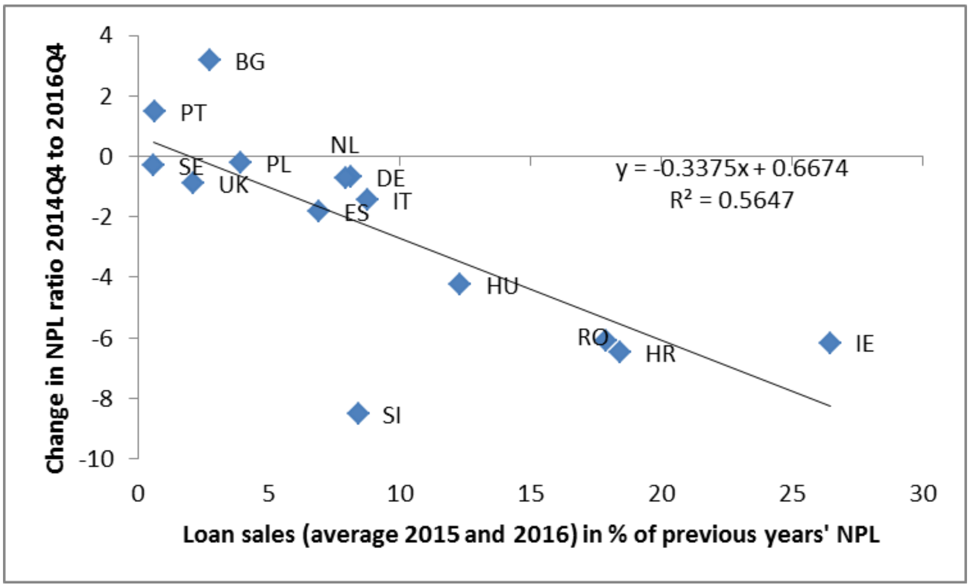
The chart below applies the same methodology, but does not take loan sale and NPL volumes in EUR, but as a ratio to the stock of NPLs and total loans, respectively. This is an implicit control for the size of the market and avoids that Member States with large NPLs have a dominant impact on the correlation. The correlation is insignificant and the R2 small unless the UK as outlier is excluded from the panel. If the UK observation is not considered, the regression line suggests that a 1 %-pt increase in the ratio of loan sales to NPL volumes decreases the NPL ratio by 0.3%-pts.

Figure A 4.4 Loan sales and change in NPL ratios across EU Member States



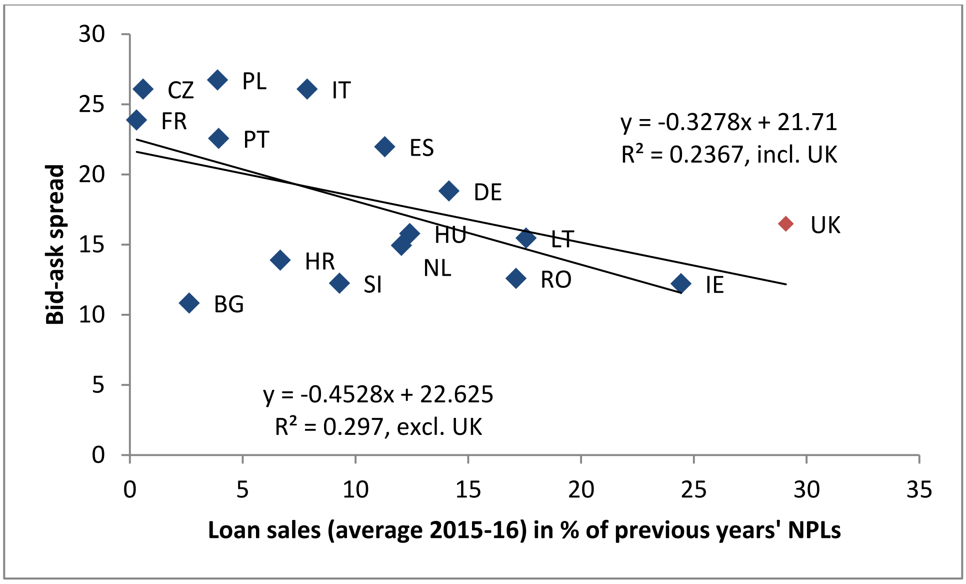
The next chart applies the same methodology, but uses a different data set, namely loan sales submitted and calculated by AFME on the basis of data collected from KPMG from public data sources. This data set includes an observation for SE, but misses some EU Member States (FR, LT). Numbers are broadly comparable with the exception of those for UK and HR. Still, the slope coefficient is similar and the share explained by the regression line somewhat higher, even if the UK is not excluded from the panel.

Figure A 4.5 Loan sales and change in NPL ratios across EU Member States (alternative data source)



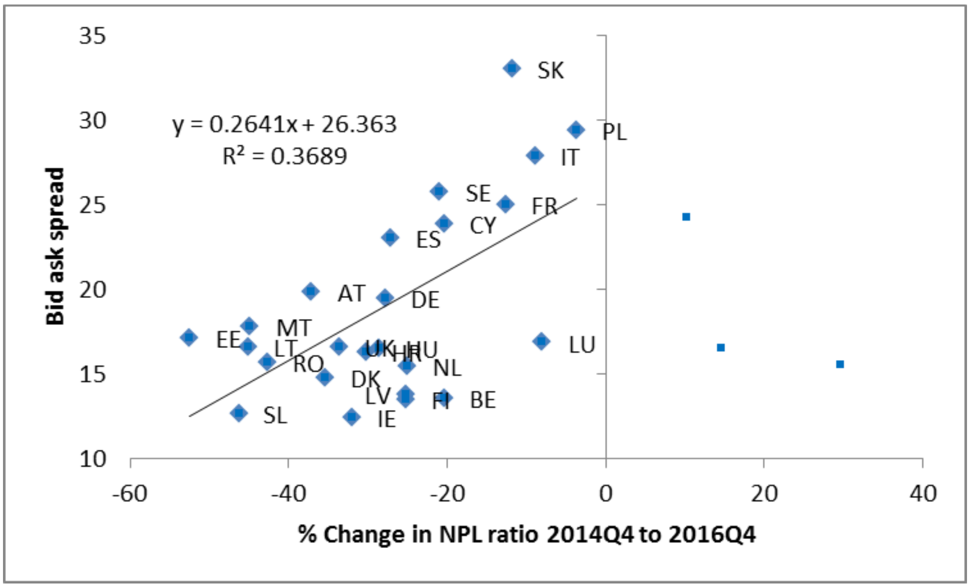
A further cross-country comparison shows some correlation between loan sales and the bid-ask spread derived from the theoretical model presented in Annex 4.3. While the R2 is not particularly high, the correlation is significant at 5% level independent of whether the UK is included into the sample or not. Though the regression analysis gives no information about causality, it suggests a 10%-pts decline in the bid-ask spread would be consistent with an 3.3 to 4.5 %pt increase in loan sales relative to the outstanding NPL stock. If the initial NPL ratio or the market size are added as additional control variable, they does not come out significant, and do not change the significance of the bid-ask spread.

Figure A 4.6 Loan sales and bid ask spread across EU Member States



Since for some Member States there is not data about loan sales, it is also interesting to directly compare the bid-ask spread derived from the model with the change in NPL ratios. For both data is available for all Member States, bar CZ for which the NPL ratio in the ECB data set starts only with the observation of 2016Q1. The relationship between bid-ask spread and the change in the NPL ratio from 2014Q4 to 2016Q4 is not significant. This, however, changes, if the observations for those Member States, in which the NPL ratio increased over these two years are excluded from the panel (BG, EL and PT). Since the reasons for an increase in the NPL ratio are unrelated to the bid-ask spread that impacts the loan sales, such elimination of single observations from the data set seems justified. The correlation become significant and suggests Member States with a lower bid-ask spread were able to realise a relatively larger decline in their banks' NPL ratio. The slope coefficient suggests a 1 %pt lower bid-ask spread reduces the NPL ratio by 1.6%.

Figure A.4.7 Change in NPL ratio and bid ask spread across EU Member States



The table below shows the numerical results of the different specifications.

Table A4.1 Regression results, cross-country OLS, dependent variables Loan sales (upper panel) and change in NPL ratio (bottom panel)

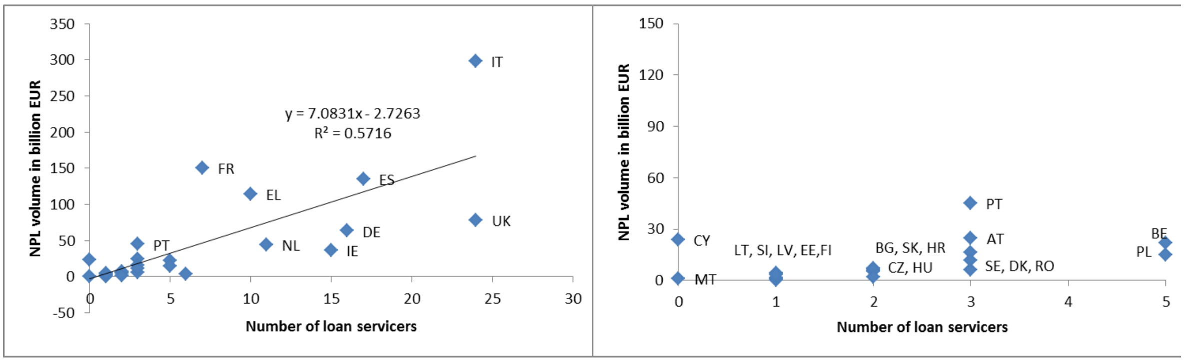
		Constant	Bid-ask spread	R2	obs.
	Transactions in loan sales				
Data set 1		23.94	-0.72	0.24	16
	t-value	3.65	-2.08		
Data set 1 ex UK		21.60	-0.66	0.30	15
	t-value	4.04	-2.34		
Data set 2		21.43	-0.70	0.27	14
	t-value	3.44	-2.09		
		% Change in NPL ratio			
Data set 3		-38.35	0.89	0.05	27
	t-value	-2.81	1.20		
Data set 3 ex BG, EL and PT		-57.04	1.65	0.39	24
	t-value	-7.10	3.79		

Note: Bid ask spreads as derived in Annex 4.3. Data set 1 combines observations of loan sales 2015 and 2016 in PWC (2017) and Deloitte (2017). Data set 2 uses the AFME (2017) calculations with KPMG data of loan sales. All loan sale data is relative to the ECB data of NPL volumes. Data set 3 uses the change in the ECB's NPL ratio 2014Q4 to 2016Q4 (2015Q1 for those Member States that had no observation for 2014Q4).

There is also a broad correlation between the number of loan servicers active in a

Member State and the volume of NPLs. The number of loan servicers is taken from Table A2 in Annex 5.2. The right-hand panel zooms in on smaller Member States, that are not clearly visible in the left-hand panel. The comparison suggests that the number of loan servicers relative to the amount of non-performing loans is small in Italy, France, and despite numerous authorisations recently in Greece.[110] Spain and Portugal are borderline cases. The UK is also an outlier since it has many loan servicers. This might be explainable by the role loan servicers have in supporting securitisation activity or the outsourcing of the management of real estate loans in the UK.

Figure A.4.8 Number of loan servicers and NPL volume across EU Member States



Although the cross-country comparisons produce plausible coefficients, the small number of observations and the data caveats listed above suggest that the result are best treated as illustration and not at statistical evidence. Results may not be robust and change once the analysis is re-run with observations for more countries or additional years.

110 The first loan servicer was authorised in Greece in July 2017. By December 2017, the Greek Central Bank authorised 10 firms.

3. QUANTIFYING THE IMPACT OF THE DIFFERENT POLICY OPTIONS ON NPL SECONDARY MARKETS- EXPLANATION AND ASSUMPTIONS

Inefficiencies in the pricing of NPLs show up as relatively wide spreads between the ask price from the sellers of NPLs and the bid price from buyers. Then, one of the goals of the difference policy options is to improve NPLs secondary market efficiency helping to reduce such spread. We observed that a reduction in the bid-ask spread is correlated with a reduction in the NPL ratio.

Pricing model for the bid-ask spread

We have implemented a theoretical model to calculate the bid ask spread on NPLs for the EU MS:

We apply the methodology proposed by Ciavoliello, et al (2016) and proceeded as follows:

1. The future value of a loan that performs and that matures at time n is Fn. This loan has cash flows (f_t) from now until maturity in time n. We use the loan effective rate (i) to calculate the future value.

$$F_n = \sum_{t=1}^{n} f_f * (1+i)^t = 100$$

2. To calculate the present value of a performing loan (Gross Book Value or GBV_u) we discount the future value of the loan (Fn) using the loan effective interest rate (i). Thus:

$$GBV_u = \frac{F_n}{(1+i)^n}$$

3. If the loan defaults or does not perform (NPL), the owner (bank) of the loan can only recover a percentage on the GBV_u (recovery rate = rr). Then the Gross Book Value of the defaulted loan (GBV_d) is:

$$GBV_d = GBV_u * rr$$

4. If the loan becomes non-performing it incurs in some costs to either default management or loss mitigation that we name indirect costs (ic). These costs are the fee that the loan servicer will charge for their services and it is a percentage of the Gross Value of the default loan. Then, the net value of the default loan (NBV_d) is:

$$NBV_d = GBV_d(1 - ic)$$

5. Then, the bank with NPL has to provision for the losses in the loan. The provisions should be the difference between the GBV_u and the GBV_d :

$$Provision = GBV_u - GBV_d$$

6. To avoid further losses on the loan, the bank will be willing to sell the NPL at GBV_d . Any price above this value will generate profits and any price below will further damage the bank profitability and its capital position. Then, our ask price estimation for the loan, the minimum price at which the bank would be willing to sell the loan, is GVB_d :

$$ask = GVB_d$$

7. The ask price will be higher if the NPL is under provision to avoid inputting further losses in the income statement. The more in need of capital and under provisioned the higher the ask price by the seller bank.

$$if\ provision < \ GBV_u - GBV_d$$

$$ask = GVB_u - provision$$

8. Potential NPL buyers need to take into consideration the GBV_d , the indirect costs to recover the loan (ic) and its expected profit. This expected profit should be weighted by risk. However, for simplicity reasons, our assumption is a plain profit of 15% on top of the loan effective interest rate. Then, the bid price, the maximum price that the buyer is willing to pay will be:

$$bid = \frac{F_n * rr}{(1 + i + 0.15)^n} - ic$$

9. The bid ask spread in the secondary market for NPLs will be:

$$bid\ ask\ spread = ask - bid$$

Then the drivers of the differences in bid ask spread among EU MS will be:

a. The loan effective rate
b. The time to recover the loan
c. The recovery rate
d. The indirect costs
e. The provisions
f. The buyer expected profit

Calibration of the model

To provide an estimation of the differences in bid ask spread on NPLs among MS, we have gathered information from World Bank, Doing Business 2016.

The loan effective rate is calculated for every MS using the interest rate of new lending to non-financial corporations with a maturity of 1-5 years. This data is compiled by the ECB.

We use the time to recover the loan, the recovery rate and the indirect costs provided by The World Bank in its publication Doing Business 2016. The values of these variables for each MS are calculated based on the time, cost and outcome of insolvency proceedings in a given economy.

Time remaining to collect the cash flow from the NPL loan is provided either by NBER and Doing Business. NBER data is from 2006 whereas data from World Bank is from 2016. The values are not the same but the differences are small for all the Member States but the Czech Republic and Romania.

To make the data on recovery rate comparable across countries, several assumptions about the business and the case are used. The recovery rate is recorded as cents on the dollar recovered by secured creditors through reorganization, liquidation or debt enforcement (foreclosure or receivership) proceedings. The calculation takes into account the outcome: whether the business emerges from the proceedings as a going concern or the assets are sold piecemeal. Then the costs of the proceedings are deducted (1 cent for each percentage point of the value of the debtor's estate). Finally, the value lost as a result of the time the money remains tied up in insolvency proceedings is taken into account, including the loss of value due to depreciation of the hotel furniture. Consistent with international accounting practice, the annual depreciation rate for furniture is taken to be 20%. The furniture is assumed to account for a quarter of the total value of assets. The recovery rate is the present value of the remaining proceeds, based on end-2015 lending rates from the International Monetary Fund's International Financial Statistics, supplemented with data from central banks and the Economist Intelligence Unit. It is important to note that the drivers of the recovery rate, i.e. the cost, the time and the binary outcome of the process (the company continues to operate or is sold piecemeal) are derived from questionnaire responses by local insolvency practitioners and verified by the World Bank through a study of laws and regulations as well as public information on insolvency systems. In other words, the recovery rates calculated by the World Bank are not directly based on an average of observed recovery rates.

The estimated cost of the insolvency proceeding or indirect costs are reported as a percentage of the value of the insolvency estate, borne by all parties. Costs include court/bankruptcy authority costs, attorney fees, bankruptcy administrator fees, accountant fees, notification and publication fees, assessor or inspector fees, asset storage and preservation costs, auctioneer fees, government levies and other associated insolvency costs. These costs will be mainly the fee that the third-party loan servicers will charge. Once again there are small differences or not differences at all in these values between NBER and Doing Business for all Member States but Austria, Denmark and Poland. In these three countries the indirect costs reported by NBER are substantially higher than the ones we use in our calculations.

We have made the assumption that the bank provisions the difference between the Gross Book Value of the performing loan less the Gross Book Value of the non-performing loan. If the bank has a higher provision mean it is over provisioned if the bank has a lower provision it means the bank is under provision for that NPL. Banks that are in trouble because low profitability and higher capital needs tend to be under provision, which means they will ask for a higher price that if they were better provisioned.

Finally, our assumption for the buyer (investment fund) is that it will enter the secondary market if it can make a profit. When the buyers of NPLs enter the market they will use the services of third-party loan servicers. Then, the buyers of NPLs in the secondary market will take into account in their bid price the indirect costs, or costs associated with loan servicing, and the expected profit. For the expected profit, the IRR of the external investors (hedge funds, mutual funds, other non-bank investors, etc), we have made the assumption that the external investors identify buying NPLs as a risky business so they applied an excess return of 15%[111] on top of the rate of return adjusted for country risk in each country[112]. Then the IRR in each country is the sum of the excess return because of NPL specificities + the rate of return adjusted for country risk.

Table A.4.2: Spreads in bid ask prices for NPLs in MS. Current situation

	Ccy	Future Value (EUR)	Lending rates as of Oct 2015	Time to recover (years)	Gross Book Value PL (EUR)	recovery rate per unit (t=0)	Gross Book Value NPL (EUR)	Indirect costs (EUR)	Net Book Value NPL	Ask	Buyer expected rate of return	Bid	Spread
		Fn	i	n	GBVu	rr	GBVd	ic	NBVd				
AT	EA	100,00	1,98%	1,10	97,87	0,83	82,80	8,28	74,52	82,80	16,98%	62,92	19,88
BE	EA	100,00	2,05%	0,90	98,19	0,90	89,90	3,15	86,75	89,90	17,05%	76,32	13,58
BG	BG	100,00	5,14%	3,30	84,76	0,35	34,90	3,14	31,76	34,90	20,14%	19,33	15,57
CY	EA	100,00	4,31%	1,50	93,87	0,73	72,80	10,56	62,24	72,80	19,31%	48,96	23,84
CZ	CZ	100,00	3,10%	2,10	93,79	0,67	66,50	11,31	55,20	66,50	18,10%	38,69	27,81
DE	EA	100,00	2,89%	1,20	96,64	0,84	84,40	6,75	77,65	84,40	17,89%	64,93	19,47
DK	DK	100,00	1,93%	1,00	98,11	0,88	88,00	3,52	84,48	88,00	16,93%	73,19	14,81
EE	EA	100,00	3,11%	3,00	91,22	0,40	40,30	3,63	36,67	40,30	18,11%	23,19	17,11
EL	EA	100,00	5,09%	3,50	84,05	0,36	35,60	3,20	32,40	35,60	20,09%	19,11	16,49
ES	EA	100,00	3,19%	1,50	95,40	0,78	78,30	8,61	69,69	78,30	18,19%	55,26	23,04
FI	EA	100,00	3,43%	0,90	97,01	0,90	90,30	3,16	87,14	90,30	18,43%	76,78	13,52
FR	EA	100,00	2,47%	1,90	95,47	0,79	78,50	7,07	71,44	78,50	17,47%	53,49	25,01
HR	HR	100,00	5,28%	3,10	85,26	0,34	33,70	4,89	28,81	33,70	20,28%	17,41	16,29
HU	HU	100,00	2,33%	2,00	95,50	0,43	43,00	6,24	36,77	43,00	17,33%	26,47	16,53
IE	EA	100,00	5,00%	0,40	98,07	0,88	87,70	7,89	79,81	87,70	20,00%	75,25	12,45

111 This would be the premium that market investors demand for participate in the NPL secondary market on top of adjusted rate of return. This is the premium proposed for NPL external investors in the Financial Stability Review of November 2016.

112 The return adjusted for risk includes the risk free rate and the excess return adjusted for the differences in country risk observed in MS. We approximate this return adjusted for country risk as the lending rate in each MS.

IT	EA	100,00	3,71%	1,80	93,65	0,64	63,90	14,06	49,84	63,90	18,71%	36,05	27,85
LT	EA	100,00	3,07%	2,30	93,28	0,45	45,00	4,50	40,50	45,00	18,07%	28,42	16,58
LU	EA	100,00	1,52%	2,00	97,03	0,44	43,70	6,34	37,36	43,70	16,52%	26,84	16,86
LV	EA	100,00	5,24%	1,50	92,63	0,49	49,10	4,91	44,19	49,10	20,24%	35,29	13,81
MT	EA	100,00	1,88%	3,00	94,57	0,41	40,70	4,07	36,63	40,70	16,88%	22,89	17,81
NL	EA	100,00	3,35%	1,10	96,44	0,89	89,30	3,13	86,17	89,30	18,35%	73,81	15,49
PL	PL	100,00	3,18%	3,00	91,04	0,61	60,60	9,09	51,51	60,60	18,18%	31,24	29,36
PT	EA	100,00	3,67%	2,00	93,05	0,74	74,20	6,68	67,52	74,20	18,67%	49,95	24,25
RO	RO	100,00	6,93%	3,30	80,16	0,34	34,40	3,61	30,79	34,40	21,93%	18,69	15,71
SE	SE	100,00	1,67%	2,00	96,74	0,78	77,90	7,01	70,89	77,90	16,67%	52,15	25,75
SI	EA	100,00	4,29%	0,80	96,70	0,89	89,20	3,57	85,63	89,20	19,29%	76,54	12,66
SK	EA	100,00	4,89%	4,00	82,62	0,56	55,60	10,01	45,59	55,60	19,89%	22,57	33,03
UK	UK	100,00	2,55%	1,00	97,51	0,89	88,60	5,32	83,28	88,60	17,55%	71,98	16,62
Average													19,22
Benchmarks													
JPN		100,00	4,20%	0,6	97,56	0,921	89,85	3,77	86,08	7,71	89,85	19,20%	79,11
USA		100,00	10,00%	1,5	86,68	0,786	68,13	6,81	61,32	18,55	68,13	25,00%	49,42866
CHE		100,00	4,50%	3	87,63	0,466	40,84	1,84	39,00	46,79	40,84	19,50%	25,46992

Scenario analysis

Once we have calculated the bid-ask spread in the NPL secondary for the current situation we estimated the effect that the different policy options could have on such spread. We distinguish between policy options that could increase the investor base and the policy options to improve the availability of third-party loan servicers. On the other hand, we have observed, using country data, that there is a correlation between the two year variation in the NPL ratio (NPL loans / total loans) and the bid ask spread. Applying regression analysis we estimated that for 1% decrease in the bid ask spread there is a 0.88% decrease in the NPL ratio, which means that, “ceteris paribus”, there would be a reduction of 0.88% in the volume of NPLs every two years, or 0.44% each year (see Annex 4.2). Our assumption is that such reduction on NPLs will increase the volume of transactions on NPLs or NPL sales from banks to investors. To estimate the incremental volume of NPL sales for the next two years in each MS we multiply the reduction in bid ask spread times 0.88% (this is the correlation found) and times the volume of NPL in each country at the end of first quarter of 2017, the last available information from ECB.

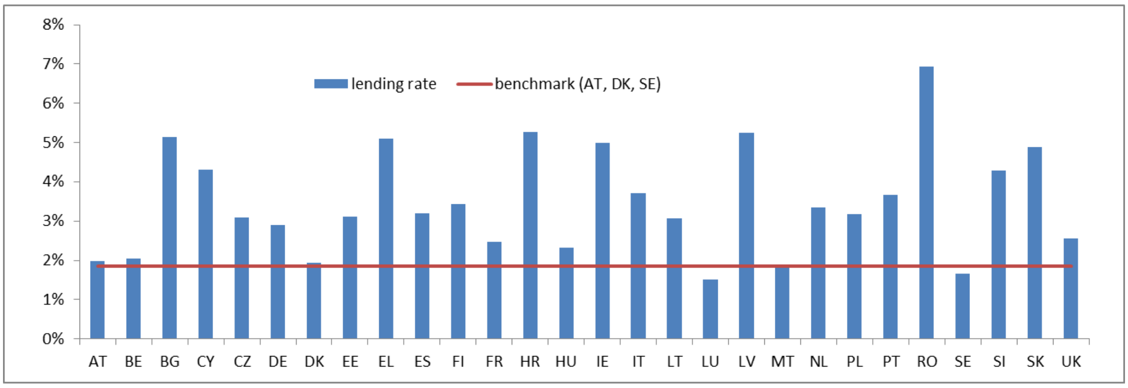
The options are: common principles, passporting and rule book for both NPL investors and loan servicers. The next step has been to quantify such policy options in the NPL market.

Policy scenarios for NPL investors

To quantify the impact of NPL investors’ policy options on NPL market our assumption is that such policy will contribute to reduce risk perception by investors in EU Member States. Such reduction will occur through a convergence in the rate of return required by investors in a market that becomes European, because of the policy measures to improve market efficiency, therefore more efficient that those MS individual markets consider isolated. Such reduction will contribute to reduce the bid ask spread in the NPL market which will increase the volume of NPL transactions.

Policy option A for NPL investors is to have minimum common standards for investors across EU Member States. To quantify the impact of such policy on NPL market our assumption is that such policy will contribute to reduce risk perception by investors in some EU MS, those with more entry barriers: BG, EL, IT, CY, HU, AT, PL, and RO. For these countries our assumption under policy option A is that they will adjust their return adjusted by country risk to the benchmark of 1.9%. The benchmark is the average lending rate of the countries with the lowest country risk. Such reduction will contribute to reduce the bid ask spread in the NPL market which will increase the volume of NPL transactions.

Figure A.4.9: Lending rates as country-specific risk premium in investors' required return



Source: Commission calculations with ECB data of MFI interest rates of new lending to non-financial corporations maturity 1-5 years in October 2015.

Policy option B for NPL investors is to implement a common passport for NPLs investors. To quantify the impact of such policy on NPL market our assumption is that such policy will contribute to reduce risk perception by investors, specifically in those EU MS with country risk above the benchmark (1.9%). We assume that all the MS will benefit of the European market framework with a reduction of 50 basis points in the rate of return demanded by investors, besides those MS with country risk above the benchmark will converge by 50% to the benchmark. The benchmark is the average lending rate of the countries with the lowest country risk. Such reduction will contribute to reduce the bid ask spread in the NPL market which will increase the volume of NPL transactions.

Policy option C for NPL investors is to implement a common rule book for NPLs investors. To quantify the impact of such policy on NPL market our assumption is that such policy will contribute to reduce risk perception by investors, such that the worst performers will adjust their rate of return to the benchmark but at the same time the best performers will also adjust to the benchmark which will penalize then. We assume that all the MS will benefit of the European market framework with a reduction of 50 basis points in the rate of return demanded by investors, besides those MS with country risk above the benchmark will converge by 50% to the benchmark whereas those MS below the benchmark will move to the benchmark reducing the distance by 25%. The benchmark is the average lending rate of the countries with the lowest country risk. Such reduction will contribute to reduce the bid ask spread in the NPL market which will increase the volume of NPL transactions.

Table A.4.3: Changes in Spreads in bid ask prices for different policy scenarios in NPL markets (convergence loan rates)

		Current spread	New spread if A	Change in Spread	incremental NPL sales (billion €)	New spread if B	Change in Spread	incremental NPL sales (billion €)	New spread if C	Chang in Spread	incrementa l NPL sales (billion €)
AT	EA	19,88	19,86	-0,02	0,00	19,52	-0,36	0,08	19,52	-0,36	0,08
BE	EA	13,58	13,58	0,00	0,00	13,23	-0,35	0,07	13,23	-0,35	0,07
BG	BG	15,57	14,89	-0,67	0,03	14,21	-1,36	0,06	14,21	-1,36	0,06
CY	EA	23,84	23,24	-0,60	0,12	22,55	-1,30	0,27	22,55	-1,30	0,27
CZ	CZ	27,81	27,81	0,00	0,00	26,82	-0,99	0,06	26,82	-0,99	0,06
DE	EA	19,47	19,47	0,00	0,13	18,74	-0,73	0,41	18,74	-0,73	0,41
DK	DK	14,81	14,81	0,00	0,00	14,47	-0,34	0,05	14,47	-0,34	0,05
EE	EA	17,11	17,11	0,00	0,00	16,35	-0,77	0,00	16,35	-0,77	0,00
EL	EA	16,49	15,79	-0,70	0,70	15,07	-1,42	1,43	15,07	-1,42	1,43
ES	EA	23,04	23,04	0,00	0,00	22,10	-0,94	1,12	22,10	-0,94	1,12
FI	EA	13,52	13,52	0,00	0,00	12,75	-0,78	0,03	12,75	-0,78	0,03
FR	EA	25,01	25,01	0,00	0,00	24,23	-0,78	1,03	24,23	-0,78	1,03
HR	HR	16,29	16,29	0,00	0,00	14,98	-1,31	0,06	14,98	-1,31	0,06
HU	HU	16,53	16,45	-0,08	0,00	16,12	-0,40	0,02	16,12	-0,40	0,02
IE	EA	12,45	12,45	0,00	0,00	11,88	-0,58	0,18	11,88	-0,58	0,18
IT	EA	27,85	27,39	-0,46	1,20	26,77	-1,09	2,85	26,77	-1,09	2,85
LT	EA	16,58	16,58	0,00	0,00	15,87	-0,71	0,01	15,87	-0,71	0,01
LU	EA	16,86	16,86	0,00	0,00	16,58	-0,29	0,01	16,69	-0,18	0,01
LV	EA	13,81	13,81	0,00	0,00	12,69	-1,11	0,01	12,69	-1,11	0,01
MT	EA	17,81	17,81	0,00	0,00	17,47	-0,35	0,00	17,47	-0,34	0,00
NL	EA	15,49	15,49	0,00	0,00	14,61	-0,89	0,35	14,61	-0,89	0,35
PL	PL	29,36	28,92	-0,44	0,06	28,17	-1,19	0,16	28,17	-1,19	0,16
PT	EA	24,25	24,25	0,00	0,00	22,91	-1,35	0,53	22,91	-1,35	0,53
RO	RO	15,71	14,67	-1,03	0,06	13,78	-1,92	0,11	13,78	-1,92	0,11
SE	SE	25,75	25,75	0,00	0,00	25,24	-0,51	0,05	25,36	-0,39	0,04
SI	EA	12,66	12,66	0,00	0,00	11,74	-0,92	0,03	11,74	-0,92	0,03
SK	EA	33,03	33,03	0,00	0,00	30,77	-2,26	0,04	30,77	-2,26	0,04
UK	UK	16,62	16,62	0,00	0,00	16,08	-0,55	0,38	16,08	-0,55	0,38
Total					2,32			9,40			9,38

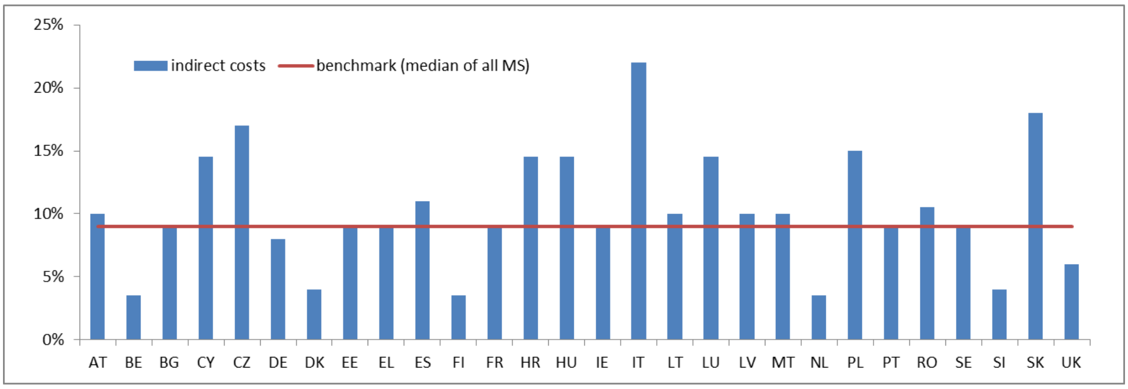
Policy scenarios for loan servicers

To quantify the impact of NPL investors' policy options on loan servicers market our assumption is that such policy will contribute to increase the number of third-party loan servicers in MS which we associate with a reduction in the barriers of entry and in the costs of providing loan servicing. Such reduction will occur through a convergence in the cost of servicing that will improve market efficiency, therefore more efficient that those MS individual markets consider isolated. Such reduction will contribute to reduce the bid ask spread in the NPL market which will increase the volume of NPL transactions.

Policy option A for NPL investors is to have minimum common standards for loan servicers across EU MS. To quantify the impact of such policy on NPL market our assumption is that such policy will contribute to reduce servicer costs in some EU MS, those with more barriers: EL,IT,CY and AT. For these MS our assumption under policy option A is that they will be able to adjust their cost by 10%. Such reduction will contribute to reduce the bid ask spread in the NPL market which will increase the volume of NPL transactions.

Policy option B for NPL investors is to implement a common passport for loan servicers. To quantify the impact of such policy on NPL market our assumption is that such policy will contribute to reduce loan-servicing costs by 10% in all countries due to the higher size of the market and those MS with cost above the benchmark will close the gap by 50%. The best performers MS in terms of cost will be able to keep such advantage. The benchmark is the average cost among those countries with the best cost records. Such reduction will contribute to reduce the bid ask spread in the NPL market which will increase the volume of NPL transactions.

Figure A.4.10: Indirect costs of loan recovery as indicator of costs of loan servicing



Source: Commission calculations with World Bank Doing Business 2016 data of insolvency – cost of recovery in %.

Policy option C for NPL investors is to implement a common rule book for loan servicers. To quantify the impact of such policy on NPL market our assumption is that such policy will contribute to reduce loan-servicing costs by 10% in all countries due to the higher size of the market and the cost gap between each country and the benchmark will close the gap 50%. The best performers MS in terms of cost will suffer an increase in their cost due to the convergence to the benchmark. The benchmark is the average cost among those countries with the best cost records. The reduction in costs will contribute to reduce the bid ask spread in the NPL market which will increase the volume of NPL transactions.

Table A.4.4: Changes in Spreads in bid ask prices for different policy scenarios in NPL markets (convergence costs)

		Current spread	New spread if A	Change in Spread	incremental NPL sales (billion €)	New spread if B	Change in Spread	incremental NPL sales (billion €)	New spread if C	Change in Spread	incremental NPL sales (billion €)
AT	EA	19,88	19,05	-0,83	0,18	18,64	-1,24	0,27	18,64	-1,24	0,27
BE	EA	13,58	13,58	0,00	0,00	13,27	-0,31	0,06	14,51	0,92	-0,18
BG	BG	15,57	15,57	0,00	0,00	15,25	-0,31	0,01	15,25	-0,31	0,01
CY	EA	23,84	22,79	-1,06	0,22	20,79	-3,06	0,64	20,79	-3,06	0,64
CZ	CZ	27,81	27,81	0,00	0,00	24,02	-3,79	0,24	24,02	-3,79	0,24
DE	EA	19,47	19,47	0,00	0,00	18,79	-0,68	0,38	19,00	-0,46	0,26
DK	DK	14,81	14,81	0,00	0,00	14,46	-0,35	0,05	15,56	0,75	-0,11
EE	EA	17,11	17,11	0,00	0,00	16,75	-0,36	0,00	16,75	-0,36	0,00
EL	EA	16,49	16,17	-0,32	0,32	16,17	-0,32	0,32	16,17	-0,32	0,32
ES	EA	23,04	23,04	0,00	0,00	21,39	-1,64	1,96	21,39	-1,64	1,96
FI	EA	13,52	13,52	0,00	0,00	13,21	-0,32	0,01	14,45	0,93	-0,04
FR	EA	25,01	25,01	0,00	0,00	24,30	-0,71	0,93	24,30	-0,71	0,93
HR	HR	16,29	16,29	0,00	0,00	14,87	-1,42	0,07	14,87	-1,42	0,07
HU	HU	16,53	16,53	0,00	0,00	14,72	-1,81	0,11	14,72	-1,81	0,11
IE	EA	12,45	12,45	0,00	0,00	11,67	-0,79	0,25	11,67	-0,79	0,25
IT	EA	27,85	26,44	-1,41	3,69	22,29	-5,56	14,59	22,29	-5,56	14,59
LT	EA	16,58	16,58	0,00	0,00	15,90	-0,68	0,01	15,90	-0,68	0,01
LU	EA	16,86	16,86	0,00	0,00	15,03	-1,84	0,06	15,03	-1,84	0,06
LV	EA	13,81	13,81	0,00	0,00	13,07	-0,74	0,01	13,07	-0,74	0,01
MT	EA	17,81	17,81	0,00	0,00	17,20	-0,61	0,01	17,20	-0,61	0,01
NL	EA	15,49	15,49	0,00	0,00	15,18	-0,31	0,12	16,41	0,92	-0,36
PL	PL	29,36	29,36	0,00	0,00	26,63	-2,73	0,36	26,63	-2,73	0,36
PT	EA	24,25	24,25	0,00	0,00	23,58	-0,67	0,26	23,58	-0,67	0,26
RO	RO	15,71	15,71	0,00	0,00	15,09	-0,62	0,03	15,09	-0,62	0,03
SE	SE	25,75	25,75	0,00	0,00	25,05	-0,70	0,07	25,05	-0,70	0,07
SI	EA	12,66	12,66	0,00	0,00	12,30	-0,36	0,01	13,42	0,76	-0,02
SK	EA	33,03	33,03	0,00	0,00	29,53	-3,50	0,06	29,53	-3,50	0,06
UK	UK	16,62	16,62	0,00	0,00	16,09	-0,53	0,37	16,75	0,13	-0,09
Total					4,41			21,27			19,74

Extension of the policy scenarios

Additionally, we have consider the improvement in the time to recover the defaulted loans because of these policies or even because other initiatives on NPLs, for instance AECE. As a reduction in the time to recover loans favours the shrinkage of bid-ask spread, we have estimated the incremental volumes of NPL sales if time to recover adjusts to the values proposed in the AECE Impact assessment.

Table A.4.5: Changes in spread in time to recover adjust ACE

	Current spread	New spread if time to recover ACE	Change in Spread	incremental NPL sales (billion €)
AT	19,88	19,88	0,00	0,00
BE	13,58	13,58	0,00	0,00
BG	15,57	12,70	-2,87	0,13
CY	23,84	23,84	0,00	0,00
CZ	27,81	25,73	-2,08	0,13
DE	19,47	19,47	0,00	0,00
DK	14,81	14,81	0,00	0,00
EE	17,11	14,44	-2,67	0,01
EL	16,49	13,30	-3,19	3,21
ES	23,04	23,04	0,00	0,00
FI	13,52	13,52	0,00	0,00
FR	25,01	23,33	-1,68	2,22
HR	16,29	13,78	-2,51	0,12
HU	16,53	15,62	-0,91	0,05
IE	12,45	12,45	0,00	0,00
IT	27,85	26,83	-1,03	2,69
LT	16,58	14,74	-1,84	0,01
LU	16,86	15,70	-1,16	0,04
LV	13,81	13,81	0,00	0,00
MT	17,81	15,09	-2,72	0,02
NL	15,49	15,49	0,00	0,00
PL	29,36	25,34	-4,02	0,53
PT	24,25	22,70	-1,55	0,61
RO	15,71	12,91	-2,80	0,16
SE	25,75	24,10	-1,65	0,17
SI	12,66	12,66	0,00	0,00
SK	33,03	27,11	-5,92	0,10
UK	16,62	16,62	0,00	0,00
Total				10,22

Besides, we have estimated the incremental volumes of NPL sales if option A for NPL investors and option B for loan servicers would be adopted at the same time with and without taking into account the improvement in the time to recover the non-performing loans.

Table A.4.6. Changes in Spread if apply scenario a for NPL investors and scenario b for Loan servicers

	Current spread	New spread NPL scenario A + Loan servicers escenario B	Change in Spread	incremental NPL sales (billion €)	new spread A+B plus reduction time to recover AECE	Change in Spread	incremental NPL sales (billion €)

AT	19,88	18,62	-1,26	0,28	18,62	-1,26	0,28
BE	13,58	12,92	-0,67	0,13	12,92	-0,67	0,13
BG	15,57	13,89	-1,67	0,08	11,28	-4,29	0,20
CY	23,84	19,49	-4,36	0,91	19,49	-4,36	0,91
CZ	27,81	23,03	-4,78	0,30	21,05	-6,75	0,43
DE	19,47	18,06	-1,41	0,79	18,06	-1,41	0,79
DK	14,81	14,12	-0,69	0,10	14,12	-0,69	0,10
EE	17,11	15,98	-1,13	0,00	13,43	-3,68	0,01
EL	16,49	14,75	-1,74	1,75	11,83	-4,65	4,69
ES	23,04	20,45	-2,58	3,08	20,45	-2,58	3,08
FI	13,52	12,43	-1,09	0,04	12,43	-1,09	0,04
FR	25,01	23,53	-1,48	1,96	21,91	-3,10	4,09
HR	16,29	13,56	-2,72	0,13	11,29	-4,99	0,25
HU	16,53	14,32	-2,21	0,13	13,44	-3,09	0,18
IE	12,45	11,09	-1,36	0,44	11,09	-1,36	0,44
IT	27,85	21,21	-6,64	17,43	20,25	-7,60	19,94
LT	16,58	15,20	-1,38	0,01	13,45	-3,13	0,02
LU	16,86	14,74	-2,12	0,07	13,61	-3,26	0,11
LV	13,81	11,96	-1,85	0,02	11,96	-1,85	0,02
MT	17,81	16,86	-0,96	0,01	14,19	-3,62	0,03
NL	15,49	14,30	-1,20	0,47	14,30	-1,20	0,47
PL	29,36	25,44	-3,92	0,52	21,61	-7,75	1,03
PT	24,25	22,24	-2,01	0,80	20,79	-3,46	1,37
RO	15,71	13,17	-2,54	0,14	10,73	-4,97	0,28
SE	25,75	24,54	-1,21	0,13	22,93	-2,82	0,29
SI	12,66	11,38	-1,28	0,04	11,38	-1,28	0,04
SK	33,03	27,27	-5,76	0,10	21,79	-11,24	0,19
UK	16,62	15,54	-1,08	0,74	15,54	-1,08	0,74
Total				30,60			40,15

Conclusions

Instead of a conclusion, a word of caution is warranted. The outcome of the simulations with the pricing model is assumption-driven. The coefficients obtained in the cross-country analysis suffer from unsatisfying data and a very small number of observations. Hence, there are good reason to challenge each step in the simulations exercise and the results serve only to illustrate the issues and may help assess the relative performance of the different policy options rather than be taken as a guidance on how NPL markets can actually develop.

4. Translating the scores for the assessment criteria into an overall ranking of the policy options

The Table below summarises the ranking of the different policy options in Table 6, Table 7, and Table 8.

Table A.4.7: Summary of options and their effects

	Baseline	non-binding common principles	Directive with common standards and use of passports	Regulation with fully harmonised rules and common market supervision
	NPL investors			
1.Address failures in (national) NPL markets				
stimulates entry into MS with high entry barriers	0	+	++	+++
incentivises smaller firms to enter	0	+	+++	+++
2.Foster a single NPL market				
equal treatment across MS	0	0	++	+++
incentivises entry of firms from outside the EU	0	+	++	++
realises scale effects	0	0	0	0
3. Safeguards for borrower rights				
Ensure efficient supervision	0	-	--	---
Costs of adjustment of laws that protect borrower rights	0	-	--	---
	Loan Servicers			
1. Address failures in (national) NPL markets				
stimulates entry into MS with high entry barriers	0	+	++	+++
incentivises smaller firms to enter	0	+	++	++
2. Foster a single NPL market				
equal treatment across MS	0	0	++	+++
incentivises entry of firms from outside the EU	0	+	++	+++
realises scale effects	0	++	+++	+++
3. Safeguards for borrower rights				
Ensure efficient supervision	0	-	--	---
Costs of adjustment of laws that protect borrower rights	0	-	--	---

An overall ranking of effectiveness was derived by averaging the sum of plusses for investors and servicers. Efficiency is the difference of effectiveness and the average sum of minuses for investors and servicers.

Table A.4.8: numerical results for effectiveness and efficiency

	Baseline	Option 1 – Non-binding principles	Option 2 – Minimum standards
Effectiveness	0	8/2=4	20/2=10
Efficiency	0	4-2=2	10-4=6

Finally, a + is allocated for a score in the range 1 to 4, ++ in the range 5-8, +++ in the range 9-12.

Table A.4.9: Scoring for effectiveness and efficiency

	Baseline	Option 1 – Non-binding principles	Option 2 – Minimum standards
Effectiveness	0	+ (score 4)	+++ (score 10)
Efficiency	0	+ (score 2)	++ (score 6)

ANNEX 5: MARKET OVERVIEW

1. NATURE AND SIZE OF THE NPL MARKET

Fragmentation of market and legal conditions along the increases entry costs especially for international investors. Though there have been numerous transactions in NPLs in the EU in the last years, there is no single market for NPLs, but fragmented early stage national markets. This section reviews the available data on NPL transactions and puts them in perspective. A more comprehensive review of market conditions can be found in Bruegel (2017).

Absent public data collections, the only available numbers of NPL transactions stem from publications of consultancy firms. These collect data from public sources and may also use information from their business relationships. They report that they cannot guarantee accuracy of the data and the observation of discrepancies between data coming from different consultancies underlines the difficulty to keep track of NPL markets. Commission research on NPL transactions found that only few and large transactions are reported in main media. Smaller transactions are reported on specialised websites, but often lack details about buyer, seller and/or amounts (see also Annex 4.2).

Between 2014 and 2017, consultancies recorded transaction volumes between 100 and 150 billion EUR per annum in secondary markets for loans in the EU.[113] The consultancies that collect data do not provide information about the share of NPLs in loan sales. The three approaches presented in Annex 4.2 suggest that the average share of NPL in loan sales could be 70 to 80%. The charts below indicate the evolution of loan transactions across the main EU markets by various sources.

Box A.5.1: Caveats on the data on NPL sales

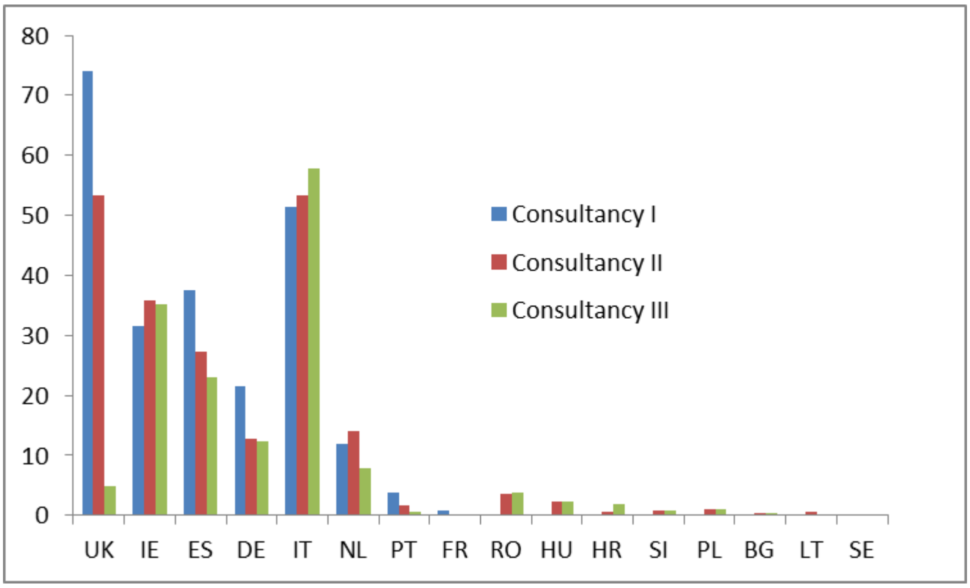
There is no official statistics on transactions data of NPLs. Official documents regularly quote data from consultancies, which report data in publications or on websites. These consultancies cannot scrutinise the data quality as rigorously as statistical offices could do. Moreover, a number of data limitations may distort the information content Bruegel 2017 lists the following:

- One cannot differentiate between non-performing assets and other non-core assets.
- If a bank sells NPLs, the transaction might be so structured that it still retains exposure to the loan.
- Buyers may be other banks, so that the NPLs remain in the banking sector.
- Non-banks may re-sell NPLs, so that the transaction volume does not reduce the NPL ratio of the banking sector.

Moreover, details of transactions are not disclosed in several cases. Sometimes the buyer, seller and/or volumes are not made public. The data collectors' different strategies to circumvent this limitation may be accountable for difference in the statistics.

113 The number is measured in book values (unpaid primary balance) and is comparable to the amount banks can free from their balance sheet. Since prices are much lower than 100%, both transaction values and invested amounts by non-banks are also smaller.

Figure A.5.1: Transaction volumes on loan markets, sum of 2015 and 2016 in billion of EUR



Source: AFME (2017), Deloitte (2017a, 2017b), PWC(2017).

The NPL market has been highly concentrated. The breakdown of transactions by country suggests strong variation, with a strong clustering in four countries: ES, IE, IT and the UK. In the former three NPL sales contributed substantially to reduced high NPL ratios. There have been few transactions In other countries with high NPL ratios (CY,EL, PT, RO, SI) and sizeable market activity in countries with low NPL ratios (UK, DE, NL). In CEEC, markets for NPLs seem emerging, but are still at infant stage.[114] The 10 largest transactions in 2015/16 accounted for one third of the transaction volume, while the other two third was distributed over about 480 transactions. Very few transactions were recorded with a volume below EUR 100 million.[115]

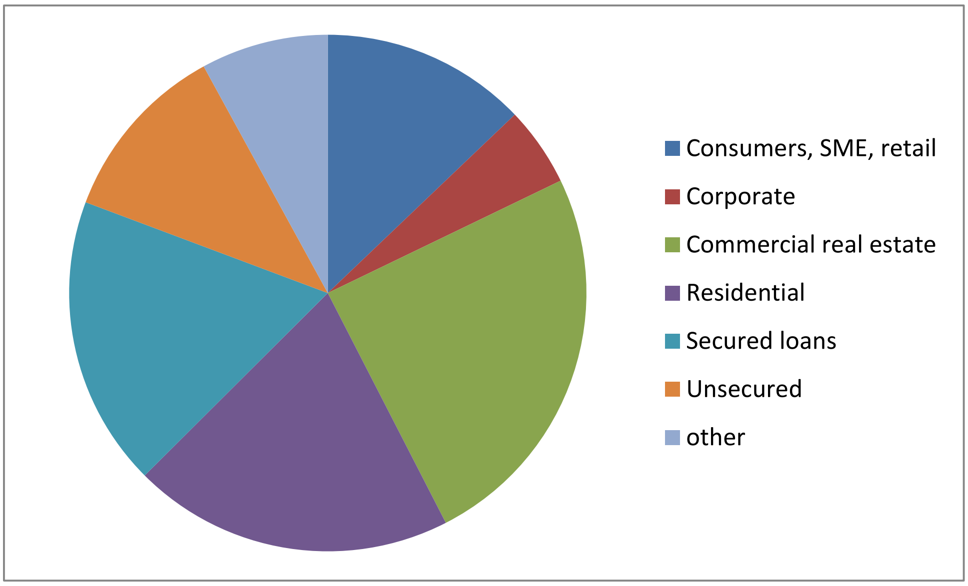
Of the 103 banks that disclosed transactions, about 40 had multiple transactions. NAMA and SAREB, the Irish respectively Spanish asset management company were the most important sellers. The loan portfolios banks sell cover very different asset classes and according to market sources some buyers are specialised in specific asset classes. The figure below gives a snapshot of market shares by asset class based from a sample of 365 NPL transactions signed in 2015-2017.

The share of loans owed by consumers is unknown because loans are sold in large portfolios, which are often mixed and do not allow to calculate a breakdown by counterpart. The share was at least 11% according to AFME (2017), see Figure A.5.2.[116]

[114] See Deloitte (2017).
[115] Around 10% in our sample.
[116] See Figure A.5.2 in Annex 5.

On banks' balance sheets, about a third of the NPL had consumers as counterpart.[117] There is little data bout the breakdown into consumer credit and mortgages[118], i.e. those being regulated through the Consumer Credit Directive and the Mortgage Credit Directive.[119] Since consumer credits are smaller, NPL purchaser are more likely to outsource their management to loan servicing firms.

Figure A.5.2: Loan sales by underlying loan category



Source: COM calculations with KPMG data, which is retrieved from publicly available sources.

On the buyer side, there are about 120 debt managers that invest in distressed debt in North America and Europe.[120] In Europe, almost 40% of the transaction deals was accountable to the biggest five buyers. More than 20 of the active investors were large investment funds with a market share of almost 50%.[121] Most buyers are investment firms, but also a few banks bought loans.[122]

Table A.5.1: Largest investors in distressed debt (Source: Prequin)

Firm	origin	Total Funds Raised in Last 10 Years ($mn)	Estimated Dry Powder ($mn)
Fortress Investment Group	USA	15842	6884
GSO Capital Partners	USA	19403	4970

117 34.8% in 2016 according to ECB data.

118 Mortgage loans to households were EUR 4189 billion at end 2016 and credit for consumption o households 1049 billion, without, however a breakdown into performing and non-performing loans available in ECB statistics. In Portugal, the NPL ratio of mortgages was 6.7% and that of consumer credit NPLs at 10% according to European Commission (2017c).

119 Directive 2008/48/EC and Directive 2014/17.

120 Prequin special report: Distressed debt in North America and Europe. 2016.

121 See Brugel (2017).

122 In our sample 15 banks accounting for 12% of the transaction volume.

Centerbridge Capital Partners	USA	17640	4724
Sankaty Advisors	USA	13184	3595
Oaktree Capital Management	USA	55686	3590
CarVal Investors	USA	13968	2499
Avenue Capital Group	USA	19041	2133
Castlelake	USA	4269	1999
Catalyst Capital Group	CND	3269	1967
Cerberus Capital Management	USA	9329	1923

The table below breaks down investors into EU NPLs by the amount of national markets they were active in. The dominant number of investment firms was active in only one market and a few concentrated on 2 or three markets. The small number of investment firms active on four or more markets accounted for about a third of all transactions.

Table A.5.3: The geographical reach of NPL investors

Number of Member States invested in	number of firms	number of transactions	average transaction size in million EUR
>4	11	110	573.3
3	5	28	756.3
2	10	65	503.0
1	85	116	616.6

Source: COM calculations with KPMG data, which is retrieved from publicly available sources.

Table A.5.4. Main European NPL investors and key company figures

Company name	HQ	Number of countries where it operates	of which EU	Operating income/revenue	EBITDA	total assets
B2 Holding	NO	23	20	125.23	143.24	630.88
Eos Group	DE	26		677.56	226.61	1 526.34
Kruk Group	PL	9	9	185.98	86.07	734.92
Hoist Group	SE	11	11	225.60	293.27	1 922.65
Intrum	SE	23	23	611.24	329.61	1 446.16
Axactor	NO	5	4	38.88	-0.01	271.89
BancaIFIS	IT	1	1	237.69	66.27	4 995.60
Idea Fimit	IT	1	1			
LCM Partners	UK	10	10			
APS group	LU	11	11	26.26	10.17	40.88

2016 numbers in million EUR. Company numbers relate to the total group, not its NPL business.

Source: Company annual reports 2016.

Though not all NPL buyers have been investment funds, they represent a sizeable market share. As regards the potential investor base for NPL, it is interesting to identify investment funds that specialised in comparable products. The table below shows the free capacity debt investment funds had, using a mathematical approach to allocate the known data about geographical focus and product focus to the individual cells. The approach shows that distressed debt investors in North America have almost two times investment capacity than European investors. Other asset classes are smaller and also more dissimilar to NPLs.

Table A.5.6: Estimated dry powder of investment funds specialised in private debt strategies, billion EUR 2017H.

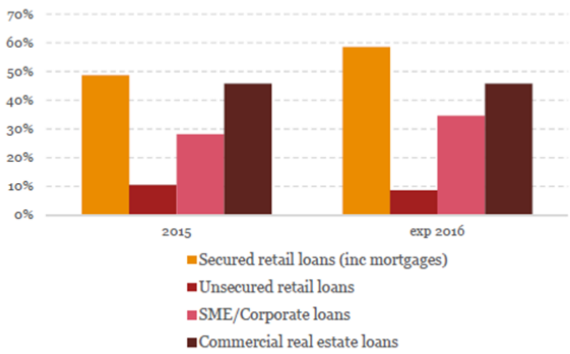
	Direct Lending	Mezzanine	Venture Debt	**Distressed Debt**	Special Situations	known total
North America	47.1	39.4	1.3	51.8	17.7	157.3
Europe	19.3	16.2	0.5	**21.3**	**7.3**	64.6
Asia	3.1	2.6	0.1	3.5	1.2	10.5
Rest of World	0.5	0.5	0.0	0.6	0.2	1.8
known total	70.1	58.7	1.9	77.1	26.4	234.2

Source: Commission calculations with Preqin data using the entropy approach. [123]

Price data is usually not disclosed and some cases are reported that deals were aborted because banks and prospective buyers could not agree on the price. If prices are lower than what banks provisioned they realise a loss, which reduces their capital and therefore inhibits their incentive to enter into a sales' deal. These coverage ratios differ strongly across banks, being smaller in small than in large banks and stand at around 44% at the EU aggregate level.[124] Hence, for a price lower than 56% (100% - 44%), the "average" bank would have to record a loss. There is a perception that EU banks may under-provision their NPLs, derived from the observation that US coverage ratios were about 20 percentage points higher.[125]

The figure below shows average prices of NPL portfolio transaction taken from a consultancy publication. It demonstrates that prices vary strongly depending on the type of debt and the quality of the underlying collateral.

Figure A.5.3: Average price on face value of NPL portfolio transactions



[123] Measured as dry powder, which consists of capital raised, capital committed and capital raised in the past, but not yet deployed.
[124] See FSC report, section 2.2.2.
[125] See IMF euro area selected issues 2015.

Source: AFME (2017) quoting PWC data.

More information needs to rely on transactions reported in the press. For few selected transactions, media or analytical reports quote or derive price data. For example, Unicredit's sale of 17 billion EUR NPLs to PIMCO in August 2017 was reported to have yielded 13%[126], MPS sale of junior NPL tranches to the Atlante II fund at 21%[127], Carlites purchase of 900 million from Caixabank in 2015 at 25%[128], Algebris reportedly paid 35% for a secured 750 million EUR NPL portfolio from Italian Banco BPM in 2017,[129] Axactor revealed it bought several portfolios of Spanish consumer loans between 6 and 7% in March 2016.[130] For comparison, the FDIC, which is the public institution in the USA in charge or resolving banks, realised 8-30% sales price relative to book value on NPLs (see Table A.5.7).

Table A.5.7: Prices on secondary markets for loans in the USA

126 https://www.reuters.com/article/us-italy-banks-unicredit-npl-idUSKBN1A21SU

127 IMF Global market monitor on 5 July 2017

128 https://www.copernicusservicing.com/goldman-sach-cleans-caixabank/

129 https://www.bloomberg.com/news/articles/2017-06-09/algebris-said-to-be-winning-bidder-in-banco-bpm-bad-loan-sale

130 http://epub.artbox.no/axactor/ar2016eng/#14/z

FDIC loan sales (USD values in million)

Loan Type	Book Value	Appraised Value	Sales Price	# Sold	% of SP/BV	% of SP/AV
			2016			
Performing	$1.60	$1.02	$1.30	11	81.25%	127.45%
Non-performing	$15.74	$1.72	$1.28	16	8.13%	74.42%
Total 2016	**$27.76**	**$6.31**	**$6.40**	**135**	**23.06%**	**101.43%**
			2015			
Performing	$347.59	$170.89	$236.91	2,904	68.16%	138.63%
Non-performing	$402.34	$107.06	$110.61	2,666	27.49%	103.32%
Total 2015	**$1,724.13**	**$717.45**	**$686.85**	**11,187**	**39.84%**	**95.74%**
			2014			
Performing	$197.94	$124.42	$133.90	1163	67.65%	107.62%
Non-performing	$309.80	$66.62	$64.40	577	20.79%	96.67%
Total 2014	**$771.64**	**$309.54**	**$321.63**	**2,499**	**41.68%**	**103.91%**
			2013			
Performing	$53.80	$33.99	$37.00	589	68.77%	108.86%
Non-performing	$43.21	$12.56	$14.60	177	33.79%	116.24%
Total 2013	**$259.88**	**$98.38**	**$109.96**	**1,555**	**42.31%**	**111.77%**
			2012			
Performing	$497.2	$265.35	$378.81	3621	76.19%	142.76%
Non-performing	$123.45	$31.19	$37.43	768	30.32%	120.01%
Total 2012	**$1,108.63**	**$504.29**	**$672.42**	**7,801**	**60.65%**	**133.34%**

Note: Totals include sales of portfolios consisting of subperforming and non-performing loans.
Source: FDIC

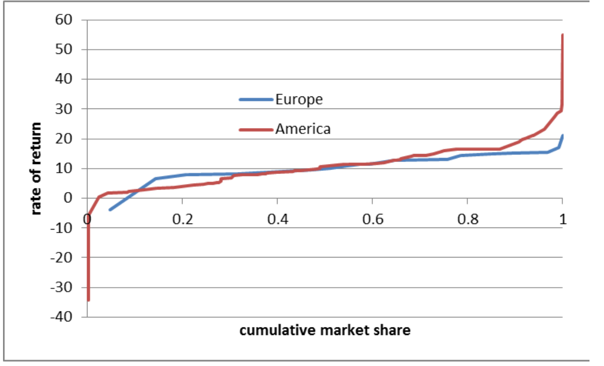
For some debt funds, profitability numbers are available. The number is however small, especially for funds with a geographical focus on Europe. According to the data available, average and median profitability was a bit higher in Europe than in America. At the polar spectrum of the distribution, differences in profitability are more pronounced, with low-profitability European investments being relatively more profitable than American ones and vice versa for high-profitability investments[131].

[131] The term "Investments" is here used for the geographical focus.

Table A.5.8: Profitability in % of investment funds specialised in distressed debt with a focus on either

	America	Europe
average	11.1	11.6
median	10.7	12.1
weighted average	10.9	10.5
Observations	69	18
missing observations	31	8

Figure A.5.4: Distribution of profitability of investment funds specialised in distressed debt



Note: Profitability measure is the net internal rate of return of the latest available observation. In most cases 2017Q2. Missing observations are those funds for which no profitability number was displayed.
Source: Commission calculations with Preqin data.

Box A.5.2: Other determinants of the bid-ask gap

Market practitioners signalled other factors that cause a high bid ask spread in NPL transactions.[1]

Different discount rates: As required by IAS 39, banks use the effective interest rate on the loans. Investors use their required returns, which typically exceed 15%.

Administrative expenditure: Banks use administrative expenses and servicing fees in their financial statement of the year in which they are incurred while investors deduct such costs from the value when they calculate the net present value.

Reputational effects: Banks attach an extra value to loans from debtors, which whom they have a long-term business relationship. They may not want to undermine the reputation they had built up with customers important to them.

Poor data quality on loans and incomplete information on collateral value. Non-bank investors need to spend resources in understanding the value of the NPL portfolio that is for sale.

Costs of capital and taxation. Non-banks may have higher costs of funding and be exposed to extra costs linked to the transfer of the loan such as for registration.

As regards the underlying information asymmetry as genuine reason for high bid-ask spreads, several mechanisms have emerged endogenously to reduce their importance. Market participants signalled that the outlook for repeated transactions creates an incentive for banks to fairly represent the value of the loans they offer for purchase. Collateralisation of loans also helps because it puts a floor on the value of loans, provided the potential buyer is able to ascribe a value to the collateral.[1] Still, market participants flagged in the public consultation that data issues are a very important concern for them. A specific workstream in the NPL Action Plan is meant to address this issue.

A further mechanism in addition to information asymmetries is that consultancy firms or other intermediaries bring together potential buyers and sellers. They assist in assessing the value of the portfolio by scrutinising loans, collateral and data quality. They invest their reputation to overcome the effect of information asymmetry and contribute to reducing the spread between bid and supply so that demand and supply can meet. They also have an indispensable role because of their knowledge of past deals to which they contributed, which means these are the only players that have some kind of market overview of prices, loan quality, collateral and other conditions.

The involvement of specialised information intermediaries does not totally reduce the bid-ask spread as they charge a fee for their services. Moreover, intermediation does not mean that market functioning is imitated. Intermediaries and big potential investors have an incentive to limit competitive pressure in order to benefit from a positive bid-ask spread and the scope to exploit the pressure on banks to sell, respectively.

2. NATURE AND SIZE OF THE LOAN SERVICING MARKET

About 40 groups with 100 firms are in this business line in the EU, some of them are present in different countries, others are small or specialised in specific portfolios such as real estate and combine loan servicing with other related activities. Market reports witness a sizeable number of acquisitions in the loan servicing market in the last years, some from NPL investors. Some big loan servicers entered the business of buying loans.[132]

While there are some loan servicing firms that act in different Member States, they focus on countries with already sufficient demand for loan sales. Moreover, their main entry or expansion strategy has apparently been the acquisition of existing national loan servicers, implying that expansion to a new market is difficult without national incumbents already present. For selecting loan servicers, potential NPL buyers can rely on the advice of consultancies, the ranking of around 30 firms done by S&P[133], or loan servicers also active in the USA.[134]

What are loan servicers and what do they do?

During the life of a loan one can distinguish three different roles from the lender perspective: Loan originators, Loan owners and Loan servicers. These three roles can be play within the same institution (company) or by different companies. The scenarios where these three lender roles split in different combinations are those where a portfolio of loans is securitized or when the loan originator sells or outsources a portfolio of defaulted or non-performing loans (NPLs).

Loan servicing is the administration of a loan or portfolio of loans from the time the proceeds are dispersed until the loan is paid off. Loan servicing business combines two lines of business: transaction processing and administration of defaulted loans. Transaction processing would benefit from economies of scale because can easily be automatized. However, the administration of defaulted loans needs a balance between automated defaulted loans (default management) and "hands on" default loans. The first option leads to foreclose whereas in the hands on procedure there is a loss mitigation goal that requires significant trained manpower. Loss mitigation includes loan restructuring, accepting a deed in lieu of foreclosure or approving a short sale.

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132 E.g. Hoist, Kruk Group.

133 Standards & Poors: EMEA Servicer Evaluation Industry Report 2016.

134 The US Mortgage Bankers Association ranks loan servicing firms including a short list of firms that serve non-US loans (11 entries). A few loan servicers activity in Europe are on this list including Situs, CBRE loan services, Wells Fargo.

Loan servicing services include: sending monthly payment statements and collecting monthly payments, borrower billing, payment posting, collection and loan accounting, calculation of borrower interest and fees, set up and management of bank account structures to effect dominion of cash, generation of borrower notices, payoff letters and amortization schedules, maintaining records of payments and balances, collecting and paying taxes and insurance (and managing escrow and impound funds), remitting funds to the note holder, and following up on delinquencies. Additionally they may also offer their services for: pricing loans, helping borrowers who default on their loans through loss mitigation options, due diligence advisory on the credit portfolio for disposals and acquisitions, recovery, collateral performance, foreclosure litigation, manage foreclosed properties, collateral reporting for lender credit analysis purposes, financial and collateral reporting tracking, property inspections and real estate evaluation, commercialization and sales.

Loan servicers' revenues come from the servicing fee. This fee can be either a fixed percentage of the unpaid primary balance (UPB) of the underlying loan, ancillary fees for late payment or loan modification, or interest earned on principal and interest and taxes and insurance collected by the servicer before distribution.

There are in-house and third-party loan servicers, depending on whether the loans are serviced by the loan originator or by an external company. The latter is common when a portfolio of non-performing loans is managed. Besides, they are label as captive loan servicers when the loan service firm is owned by the loan originator or by the loan owner, or if they have a unique client or their portfolio is owned mainly by one loan originator.

It is also common to distinguish between primary servicers, if the loan servicer manages performing loans, special servicers, if the loan servicer manages NPLs, or master services if loan servicer monitors a sub-servicer activity. Master servicers are responsible for the oversight of primary servicers. Furthermore, loan servicers tend to manage three asset classes, specialising in one of them or any combination of the three: asset finance, residential mortgages and commercial mortgages.

Federal Reserve Board et al. (2016) identifies two risks on loan servicers: business risk that can include legal compliance and reputational risk (due to regulations, including consumer protections) and valuation risk that refers to the firm's ability to estimate a value for its mortgage servicing activities and it is driven by interest rate and default risk.

Box A.5.3: The economic value added of loan servicers

It is debatable whether moving debt administration from a bank to a third-party loan servicer yields economic benefits beyond addressing moral hazard issues which are present in a situation where the loan originating bank maintains the loan servicing. It does not hold in general that third-party loan servicers can extract more value from a portfolio of loans than a bank can.[135] Administering an NPL portfolio is more costly than one of performing loans since it requires follow-up action such as sending letters and notices, entering into negotiations about debt rescheduling or taking legal enforcement action. Data from the US suggests that the servicing of non-performing mortgage loans costs about 13 times more than that of performing loans.[136] High NPLs bind bank operating resources and potentially prevent banks from carrying out more productive uses. This effect is particularly material in smaller banks having less specialised staff. Larger banks tend to have separate business entities to keep costs under control whereas smaller banks often have no capacity to do so.

A number of circumstances are listed below where NPL administration could be done effectively or/and efficiently by third-party servicers:

- Non-bank firms sometimes specialise in this administration, realise scale effects in IT and may resort to restructuring loans to increase the recovery value by re-negotiating payment terms and maturities.[137] Some loan servicing firms claim to increase recovery rates through cooperation and striving for amicable solutions.[138]
- If non-bank investors have higher willingness to take risks to banks, and as not being subject to bank regulation, or if they have special expertise in assessing particular market segments such as commercial real estate loans, SME loans or ship loans, they can contribute to a potentially higher valuation of NPLs than banks would. Some firms combine loan servicing with other services such as administration of commercial real estate.
- Loan servicing firms may also specialise in loan enforcement through out-of court or judicial action and benefit from either specialised legal expertise or from a longer time horizon than banks have available. Reputation effects may also impact on recovery because either the loan

135 Banks may draw advantage from conducting loan servicing in view of future loan contracts with the debtor or may find it easier to restructure loans with customers with which they hold a long-term relationship. Compared to market financing, banks have a comparative advantage in screening credit performance, but this unlikely holds for all banks and vis-a-vis firms specialised in this activity. This consideration, however, may explain why banks have an interest in keeping some NPLs on their balance sheets and also attach a higher valuation to these than external investors without interest in the long-term credit relationship would do.

136 Data from the US mortgage bankers association quoted in Federal Reserve Board et al. (2016) reveal that average servicing costs of performing loans were 175 USD and those of non-performing loans 2375 USD in 2015. From the accounts of a European firm specialised in acquiring non-performing consumer loans, one can derive collection costs of about 14% of interest collected.

137 ESRB (2017) argues that bankers have a comparative advantage in borrower relations and customer service, but not necessarily with respect to NPL resolution. Private equity and asset management firms can specialise in the operational and/or financial restructuring of viable borrowers and the maximisation of collateral value collection.

138 The opposite effect that originating banks can recover a higher value than servicing firms is claimed in a study with US mortgage funds in Thao Le (2016).

servicer can threaten more aggressively to enforce the loan[139] or the debtor may perceive such a threat when he is informed about the change of creditor.[140]

Why are loan servicers important for NPL market?

Loan servicing firms become a key player when the loan owners do not have the size and/or capabilities to cope with all the activities loan servicing requires. Loan servicing helps, also, when tighter financial regulation and increased capital requirements force financial institutions, mainly banks, to reduce their exposure to non-performing loans (NPLs). Thus, loan servicing provides an essential link between the capital market investors and ultimate borrowers.

In order to repair their balance sheet, banks can sell part or their entire portfolio of NPLs to external financial actors (non-bank): investment funds. These funds are interested in the return such portfolio of NPLs could add to their business, but they lack the expertise on loan servicing that banks have in house. Then, the new owners of the loans need to hire a loan servicer. This could be either the bank selling the NPLs or an outsourcing company. To avoid the contamination that past wrongdoing by the banks that originated the loans could produce, the new loan owners usually choose loan servicing companies without relation with the loan originator, non-bank servicers. Besides, the new loan owners can increase loan recovery if they focus on loss mitigation to improve recovery ratios and to reduce time for cashing the loan. However, handling NPLs through loss mitigation requires discretion, expertise and a huge amount of manpower.[141]

Then, expanding NPLs secondary market requires a robust third-party servicing industry to support investment funds participation. Thus, the growth of non-bank servicer industry in the US was driven by the banks' difficulties in managing their portfolios on NPLs.[142] Non-bank services advantages over in-house banks services come from their specialization on servicing NPLs and from their ability to reduce costs using technological innovations.[143]

What kind of loan servicers do we have in the EU Member States?

Many of the loan servicers in the EU are part of an investment group either because the investment company bought the loan servicer or because the loan servicer grew to

139 Banks face stronger reputation effects with respect to new lending business if debtors perceive their enforcement policy against other debtors as unfair.
140 See Experian (2017).
141 Levitin and Twomey (2011).
142 Federal Reserve Board et al., (2016).
143 Federal Reserve Board et al., (2016).

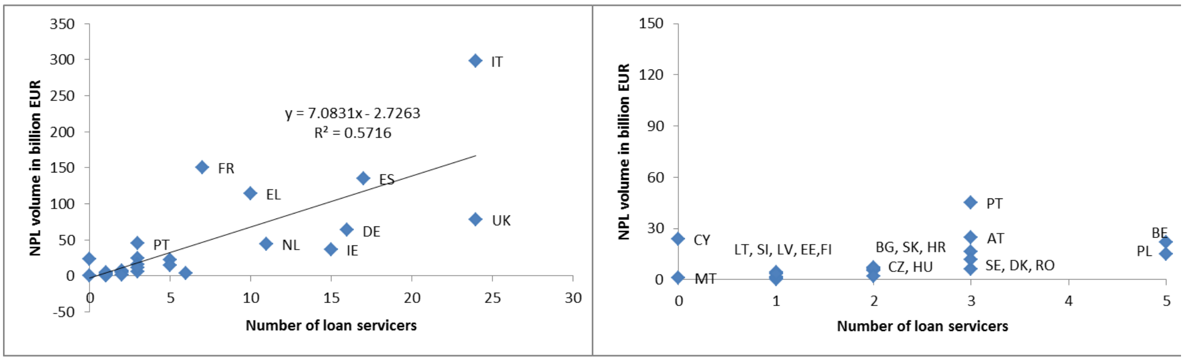
become an investor itself. There are at least 47 companies offering loan servicing in the EU. Out of the 47, 40 deal with non-performing loans, 35 deal with performing loans and only 5 monitor a subservicer. Besides, 33 out 47 deal with residential mortgages, 37 with commercial mortgages and only 7 are in the business of asset finance. At the end of 2016, our best estimate of the volume of loans under management by these loan servicers in the EU is about EUR 508 billion.

We identified loan servicers in all countries of the EU, but Cyprus and Malta. On the other hand, UK and Italy are the countries where we countered most loan servicers, 24. Germany, Spain and Ireland have 15 or 16 loan servicers operating in their countries. Netherlands, France, Poland, Belgium, or Luxembourg have 5 to 8 third-party loan servicers. The rest of the countries have a number of loan servicers inferior to 3.

The financial group that serves most countries of the EU is EOS headquartered in Germany. It is present in 18 out of 28 EU MS. Others groups with present in more than 10 countries are Intrum (recently merged with Lindorff) and Hoist Finance, which are present in 13 and 11 countries respectively. There are 9 groups that provide loan servicing in 5 or more EU countries but less than 10. Finally, there are 20 out of the 47 financial groups identified that provide loan servicing just in 1 EU country.

Relative to the stock of outstanding NPLs, the number of loan servicers is small in IT, EL, FR, PT, CY and possibly ES and AT (see Figure A.5.5).

Figure A.5.5: Number of loan servicers and NPLs per Member State (The right-hand chart zooms in on smaller Member States)

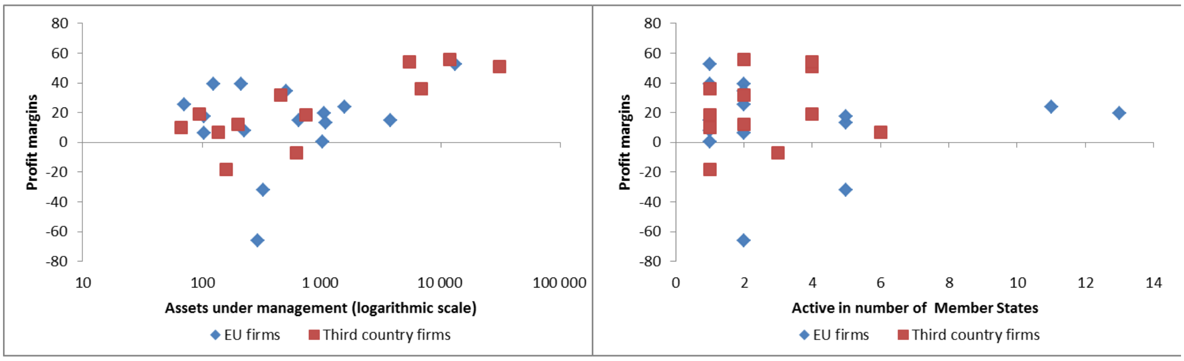


Another issue is the location of the headquarters for these groups. Thus, 15 out of 47 groups are from the USA, 9 are headquartered in the UK and the same amount in Italy, 3 from Sweden and from Germany; finally there are 2 groups from Australia, Netherlands and Spain.

Public information about profitability of these servicers is scarce. The Orbis database provides information about the profit margin of some of these groups in 2016, though not of the profitability of their loan servicing activity. Thus, among those groups where we have been able to calculate their profit margin the average value is 18% per year. The group with the highest profit margin was Blackstone that owns the loan servicer Acenden, with a 55% profit margin. Other groups with relative high profit margins were

Apollo, KKR, Oaktree or Charter Court with profit margins above 40%. Even though we have incomplete data, our best approximation for the assets under management of these groups is well above EUR 1200 billion in 2016.

Figure A.5.6: Profitability of firms offering loan servicing



Source: Company reports (see appendix).

While average Assets under Management of the 16 EU firms in this panel are 1.5 billion EUR, they are 4.7 for the 12 foreign-owned EU firms. The latest profit data (which may cover different time periods depending on the reporting date) were on average 13% for the EU firms in the panel and 22% for the foreign-owned firms. The positive relationship between size and profitability may be caused by the importance of data procession and the translation of experiences made with business practices in one Member State to another one. The pattern is less evident for EU firms, even if some of them are active in several EU Member States.

Cost structures in loan servicers

The public consultation and self-reported information from market participants suggest that EU Loan servicers are locally set with very heterogeneous environment that depends on Member States' national regulations (see Annex 3.2). The benchmark if loan servicers where homogenously regulated at the EU level could be what has happened in USA. Thus, Dodd Frank financial reform in USA prompted Banks to reduce their in house mortgage servicing that were acquired by Non-bank specialty servicers at a pace faster than their ability to handle the increased volume. Thus, non-banks' market share of USA loan servicing increased from 15% in 2008 to more than 33% in 2015.[144] The Federal Reserve Board report (2016) argues that the banks difficulties managing their portfolios of NPLs along with enforcement actions and settlements on defaulted loans are the key drives of such a growth by non-banks. Third-party loan servicers were able to benefit from their specialization on servicing non-performing loans and their ability to harness technological innovation to reduce costs.

[144] Federal Reserve Board (2016)

Such growth generated a considerable operational risk for loan servicers. Thus, subprime servicing industry was essential for development of the secondary market in subprime mortgage loans but at the same time, the accelerated growth of servicers facilitated the deterioration of the quality in subprime lending and securitization with a non-forecasted influence that servicers had on mortgage termination ((McNulty et al, 2017). Then, McNulty et al (2017) argue that the failure to regulate mortgage loan servicing is one of the causes of the USA bank failure. Servicers need to be held to a high standard. Public Administration has a role in consumer protection based on asymmetric information and market power. The borrower does not choose their mortgage servicer and cannot make changes if they don't like the servicer. (McNulty et al, 2017). In the USA case, it was not a good solution to split supervisory responsibility on loan servicers over several agencies. If the responsibility is split is possible that neither agency have incentives and/or resources to develop major expertise in the topic. (McNulty et al, 2017).

The recent regulatory requirements by USA Congress and regulatory agencies to improve the quality of servicing have skyrocketed loan servicing costs due to the introduction of complexity and the lack of a harmonized and unified set of practical standards and requirements (Housing Finance Policy Center, 2017). According to a panel of experts on loan servicing in the USA, the direct costs of servicing a performing loan per year has gone from $58 in 2008 to $164 in 2012, $205 in 2013, $170 in 2014 and $181 in 2015. The main reason for the increases in direct costs is compliance because significant regulation and legal complexity if a big part of this business (Wheeler, 2015). However, loan servicing NPLs is a much labour intensity activity which translates into direct costs of servicing these loans that are more than 10 times the costs of servicing performing loans. Besides, the direct cost of a non performing loan per year has increased four times to what it cost to service 4 years ago. Its direct cost in 2015 was $2386 while it was $482 in 2008. Mortgage loan servicing is a business where scale increases profitability.

Table A.5.8: Loan servicing costs in the USA

Annual average servicing costs (USD) in USA per loan	2008	2009	2010	2011	2012	2013	2014	2015
Servicing cost per Performing loans (USD)	$58.00	$77.00	$90.00	$96.00	$164.00	$205.00	$170.00	$181.00
Additional cost of servicing NPLs	$424.00	$626.00	$806.00	$1,266.00	$1,845.00	$2,152.00	$1,779.00	$2,205.00

Source: Federal Reserve Board (2016).

The reason for the differences in servicing costs between performing and non performing is because the direct costs associated with NPLs include the cost traditionally associated with performing loans: call center, technology, scrow, cashiering, quality assurance, investor reporting and executive management, etc, most of them able to automatize; plus the costs specific for non-performing loans: collections, loss mitigation, bankruptcy, foreclosure and post-sale, unreimbursed foreclosure and real estate owned losses, and other default specific costs. Then, we observe that servicing NPLs is much more expensive and the costs associated to those loans have been growing in the USA at a faster pace that the cost of servicing performing loans (see Table).

Table A.5.9: Changes to loan servicing costs in the USA

	2009	2010	2011	2012	2013	2014	2015	2015-2008
% change in servicing costs performing loans	32.76%	16.88%	6.67%	70.83%	25.00%	-17.07%	6.47%	212.07%
% change in servicing costs NPLs	45.85%	27.45%	52.01%	47.50%	17.32%	-17.31%	22.42%	395.02%

Source: Mortgage bankers association. Federal Reserve report

The structure of costs in a loan servicer can be divided between: Personnel 65%, Technology 30% and Ancillary 5%. Then, labour cost management, technology and innovation are essential to improve loan servicers efficiency (Accenture, 2016). However, such cost structure depends on the number of loans serviced. Thus, The Federal Reserve Report to the USA Congress shows a U behaviour for a mixture of performing and non-performing loans. Having servicers that deliver their services to a large number of loans improves their efficiency but a limit. For instance, if the EU homogenises its rules on third-party loan servicers it could be possible to take advantage of the economies of scale (Oliver Wyman, 2016).

Table A.5.10: Loan servicing costs and their determinants by firm size in the USA

Number of loans servicing	less than 2,500	2,500 to 10,000	10,000 to 50,000	Greater than 50,000
Dollar cost per servicing a performing loan in USA, 2015	$255.00	$171.00	$218.00	$243.00
% in Personnel	37.65%	44.44%	42.20%	47.33%
% in Occupancy and equipment	2.75%	2.34%	4.13%	3.29%
% Technology	0.78%	2.34%	3.67%	4.12%
% Subservicing fees	54.12%	40.94%	32.11%	21.40%
% Other expenses	4.71%	9.94%	17.89%	23.87%

Source: Mortgage bankers association. Federal Reserve report

Then, the servicer needs to get fees that are higher than its costs to be profitable. The servicing fee is a fixed percentage of the unpaid principal balance (UPB) of the underlying mortgage. The servicer may receive ancillary fees (late fees and loan modification fees) and interest earned on principal and interest and taxes and insurance collected and held by the servicer before distribution to the loan owner.

Table A.5.A1 Servicing companies in each EU MS

	Country	number of loan servicers	AuM (EUR mll)*
AT	Austria	3	
BE	Belgium	5	
BG	Bulgaria	2	
CY	Cyprus	0	
CZ	Czech Republic	2	
DE	Germany	16	€ 44,639.00
DK	Denmark	3	
EE	Estonia	1	
EL	Greece	10	
ES	Spain	17	€ 12,707.00
FI	Finland	1	
FR	France	7	
GB	Great Britain	24	€ 135,670.00
HR	Croatia	2	
HU	Hungary	3	
IE	Ireland	14	€ 113,300.00
IT	Italy	24	€ 201,274.00
LT	Lithuania	1	
LU	Luxembourg	6	
LV	Latvia	1	
MT	Malta	0	
NL	Netherlands	11	
PL	Poland	5	
PT	Portugal	3	€ 370.00
RO	Romania	3	
SE	Sweden	3	
SI	Slovenia	1	
SK	Slovakia	2	

* Information on Assets under management (AuM) is not available for all countries and for all loan servicers.

Source: Banca IFIS, EMEA service evaluation industry report by S&P and companies' webpages.

Table A5.A2 Specialization of the main loan services in the EU MS

	Primary	Special	Master	Asset finance	Commercial mortgages	Residential mortgages
Apollo non performing loan group	X	X			X	X
APS	X	X			X	X
Arrow Global Group	X	X	X		X	X
Axactor		X				
Bain Capital	X	X			X	
Blackstone (Acenden)	X	X				X
Capita Asset Services	X	X	X		X	X
CBRE loan services	X	X			X	
Cerved	X	X			X	X
Charter Court (EME)	X	X	X		X	X
Computershare (HML)	X	X				X
Cortland Capital Market Services	X				X	
Cribis Crecit Management	X	X			X	X
Davidson Kempner (PCS)		X	X	X	X	X
Dea Capital (SPC Credit Management)	X	X			X	X
FBS		X		X	X	X
Finsolutia		X				X
Fortress		X		X	X	X
Hipoges Iberia		X				X
Hoist Finance	X	X				X
Intrum	X				X	X
JB Capital Markets (SAM)		X			X	X
K.Red (Non Performing Loans spa)	X	X			X	X
KKR	X	X			X	X
Link financial outsourcing	X	X		X		
Loancos	X				X	X
Lone Star		X		X	X	X
Lowell (GFKL Financial Services)		X		X		
Mount Street Loan Solutions (MSLS)	X	X			X	
Officine CST	X	X			X	X
Pepper Finance Corp.	X	X			X	X
Primus (Centaurus Credit Recovery)		X			X	X
Quion	X	X			X	X
Securitisation Services			X	X	X	X
Situs		X				X
Solutus Advisors		X			X	
Stater	X					X
Tages (Credito Fondiario)	X		X	X	X	X
Target Servicing	X	X		X	X	X
Varde (Guber)	X	X			X	
Vesta	X	X			X	X
Wells Fargo CMS	X	X			X	

Source: Banca IFIS, EMEA service evaluation industry report by S&P, Orbis database and companies' webpages

Table A5.A.3 Characteristics of the main integrated groups of investors and loan servicers in EU

Company	HeadQ.	AuM	Employees	Profit margin	Profit per employee	Avge cost employee	Total assets per employee	EU MS
		EUR mill 16		% in 16	th EUR 16	th EUR 16	th EUR 16	
Computershare (HML)	Australia	€ 32,509.67	17,839	12.34	12		€ 201.00	2
Pepper Finance Corp.	Australia	€ 18,600.00	315	18.83	21		€ 94.00	4
APS Holding	Czech	€ 5,300.00						9
Loancos	Germany	na						1
Palmira	Germany	€ 1,200.00						6
EOS Group (Contentia, Credirect))	Germany	€ 4,565.00	15					18
Target Servicing	India	€ 6,439.56	445	10.01	11		€ 67.00	1
Cerved (Fin S. Giaco.; Recus; Tarida)	Italy	€ 12,000.00	160	39.32	88		€ 211.00	1
Cribis Crecit Management	Italy	€ 1,000.00	41	14.86	82		€ 643.00	1
Dea Capital (SPC Credit Mnt.)	Italy	€ 173.50	186	14.5	68		€ 3,768.00	1
FBS	Italy	€ 7,410.00						1
K.Red (Non Performing Loans spa)	Italy	€ 1.00	4	7.78	20		€ 224.00	1
Officine CST	Italy	€ 2,000.00						1
Primus (Centaurus Credit Recovery)	Italy	€ 3,600.00						1
Securitisation Services	Italy	€ 20,500.00						1
Tages (Credito Fondiario)	Italy	€ 4,200.00						1
Quion	Netherl.	€ 26.00	365	25.4	45		€ 71.00	2
Stater	Netherl.	€ 86.00	826	6.34	13		€ 104.00	2
Hipoges Iberia	Spain	€ 5,800.00						1
Finsolutia	Spain	€ 725.00	45	38.99	48		€ 124.00	2
Axactor (CS Union)	Sweden	€ 232,000.00	988	-32.01	-14	25	€ 324.00	5
Hoist Finance (TRC)	Sweden	€ 1,300.00	1,285	23.95	43		€ 1,560.00	11
Intrum (Lindorff)	Sweden	€ 3,352.00	8,000	19.37	71		€ 1,055.00	13
Lowell (GFKL Financial Services)	UK	€ 16,000.00						1
JB Capital Markets (Savia Asset M.)	UK	€ 2,700.00	90	0.66	1		€ 1,025.00	1
Vesta	UK	€ 500.00						1
Charter Court (Exact Mortgage Ex.)	UK	€ 21,000.00	370	52.42	154		€ 13,113.00	1
Solutus Advisors Germany	UK	€ 1,503.55	13	-66.18			€ 291.00	2
AnaCap Financial Partners	UK	€ 3,200.00	23	34.64	388	438	€ 509.00	2
Capita Asset Services (Capita M. S.)	UK	€ 111,959.34						4

Arrow Global Group (Zenith Service)	UK	€ 41,000.00	1,135	13.3	32	32	€ 1,077.00	5
Link financial outsourcing	UK	€ 4,318.68	550	17.42	15		€ 104.00	5
Davidson Kempner (Prelios C. S.)	USA	€ 9,680.00						1
Fortress (Italfon., Dobank, UCCMB)	USA	€ 72,400.00	464	18.35	70		€ 735.00	1
Cortland Capital Market Services	USA	na	3	-17.97	-8		€ 160.00	1
Wells Fargo Comm Mortgage S.	USA	€ 1,263.74	269,142	36.25	113		€ 6,803.00	1
Mount Street Loan Solutions (MSLS)	USA	€ 25,000.00	37	32	171		€ 451.00	2
Blackstone (Acenden)	USA	€ 12,051.87	2,120	55.53	1066		€ 11,815.00	2
Bain Capital (Heta Asset Resolution)	USA	€ 34,300.00						3
Cargill (Carval Investors)	USA	€ 10,000.00	18	-7.21	-80		€ 616.00	3
Lone Star (Hudson Advisors UK)	USA	€ 17,464.85						3
KKR (Sistemia)	USA	€ 40,000.00	1,200	51.11	771		€ 30,834.00	4
Apollo Global Mment (Apollo NPL G.)	USA	€ 151,000.00	986	53.85	1021	817	€ 5,416.00	4
Varde (Guber)	USA	€ 50,000.00						5
CBRE loan services	USA	€ 117,391.30	75,000	6.74	11		€ 136.00	6
Oaktree	USA	€ 86,086.96	900	43.15				6
Situs (Hatfield Philips)	USA	€ 32,000.00						6

Source: Banca IFIS, EMEA service evaluation industry report by S&P, Orbis database and companies' webpages

ANNEX 6: THE REGULATORY FRAMEWORK OF NPL TRANSFERS AND LOAN SERVICERS

1. A STOCKTAKE OF RULES IN THE EU MEMBER STATES: RESULTS OF THE QUESTIONNAIRE TO MEMBER STATES

Within the context of efforts to improve the functioning of secondary markets for distressed debt and to facilitate the disposal of non-performing loans (NPLs) by banks, the Commission sent a fact-finding questionnaire to Member States in April 2017 in order to gather information on servicing of loans by third parties and transfer of NPLs. Replies to the fact-finding questionnaire have been received from 25 Member States (MS). This text summarises the replies and represents a stock take of rules in place.

1.1 Executive summary

Most Member States lack legal definitions of loan servicing activities and concerns regarding consumer protection affect differently the activities that may be considered loan servicing. In many cases, a set of core activities performed by the creditor are defined by law and outsourcing them is generally allowed only under strict conditions such as an authorization by the competent authority or that the creditor remains, to some degree, responsible for the activity. Therefore, the particular activities that can be outsourced differ across countries.

In the large majority of Member States, there are no specific requirements for loan servicers when they enter the market, although in order to manage the loan, some countries require either a full or restricted banking license or compliance with some fit and proper criteria. Non-EU loan servicers are permitted in almost all Member States and they do not face additional requirements.

Member States have in general a favourable legal environment for NPL transfer and the entry of specialised investors. First, there is at least one type of contract in each Member State that can allow the transfer of loans without the debtor's consent. When consent is required, it is usually possible to provide it in abstract in the loan documentation and most loan contracts seem to make use of this possibility. Member States have indicated neither a separate consent for the transfer of the collateral, nor additional obstacles to transfer a loan when it is subject to enforcement actions.[145] The transfer of NPLs to non-financial institutions is also allowed in all MS, except one. Lastly, notification to the debtor is required in ten MS, and it is a standard practice even in those countries where it is not mandatory.

The Member States' responses to the questionnaire do not reveal severe additional regulatory requirements to the transfer of loans. Some types of loans, namely consumer

[145] In-court and out-of-court foreclosure proceedings.

credit or loans under a certain value face some stricter requirements on the buyer due to consumer protection provisions. In addition, the buyer is required in some cases to get a banking license. The transferor does not encounter further regulatory barriers either, although some Member States require an authorisation in case of significantly large transactions due to competition law or financial stability concerns. The questionnaire has not revealed that investment funds face any restrictions when they acquire NPLs beyond some general rules to protect retail investors.

Responses suggest that bank secrecy and data protection can be a barrier to share data for due diligence, however the legal framework of most Member States generally contains an exemption that allows the bank to disclose data which are necessary and proportionate for selling the loan. Moreover, where the debtor gives consent, which seems to be a standard practice, banks have more leeway to disclose personal information.

These results are consistent with the ECB Stocktake of national supervisory practices and legal frameworks related to NPLs (See Appendix). It should be noted however, that they reflect authorities views and our reading of what the rules intend. Market participants' perception of regulatory entry barriers and their effectiveness may differ and therefore it is warranted to cross check the conclusions with the replies from the currently running public consultation.

1.2 Background

Within the context of efforts to improve the functioning of secondary markets for distressed debt and to facilitate the disposal of non-performing loans (NPLs) by banks, the Commission sent a fact-finding questionnaire to Member States on 7 April in order to gather information on their respective relevant national legal provisions.

The aim was in particular to obtain information on:

1. servicing of loans by third parties and non-bank loan investors, and
2. transfer of loans, including non-performing loans, to bank and non-bank entities and these entities' subsequent ownership and management of these assets.

Within the context of the discussions in the FSC Subgroup on NPLs it was deemed necessary to investigate whether legal provisions might restrict the above mentioned activities in some Member States. Such restrictions may include rules for the transfer of credit contracts or restrictions applicable to purchasers of NPLs. In some cases, the transfer of a loan might only be possible with the debtor's consent. Likewise, access to information concerning the loan and/or the borrower may be restricted, for example due to considerations of data protection. Limitations can also apply to potential buyers by requiring a banking licence or by imposing other restrictions. The availability of NPL servicing also plays a role in the development of secondary markets for distressed assets. National rules, including licencing rules, governing the provision of third-party loan servicing, currently vary between Member States.

1.3. Assessment of answers to the questionnaire

1.3.1 LOAN SERVICING ACTIVITIES

1.3.1.1 Legal definitions of loan servicing activities

In most Member States, there are no formal legal definitions of 'servicing', 'managing' and/or 'debt collection' of loans, neither of other ancillary activities undertaken by banks after the granting of the loan. Loan servicing activities primarily fall under the freedom of contract.

Some Member States do put forward certain definitions/descriptions. EE establishes minimum requirements for loan servicing, which involves activities of granting loans, analysing, monitoring and evaluation. IE defines “credit servicing” as “managing and administering the credit agreement". The EL law[146] stipulates the indicative content of the management /servicing activities for NPL servicing companies as the legal and accounting monitoring, collecting, conducting negotiations with debtors. In LV, debt recovery activities fall under dedicated definitions and are regulated.[147] In the UK, a distinction is made between regulated mortgages (‘mortgage administration’[148]) and consumer credit with definition for 'debt collecting' and 'debt administration'.

1.3.1.2 Potential requirements on the outsourcing creditor[149]

In almost all Member States, there are no explicit prerequisites that a creditor has to satisfy before outsourcing certain servicing functions. As a general rule, it is not permitted to outsource core activities, which may be subject to a banking license and regulatory supervision, albeit these core activities differ depending on the Member State.

If a subset of servicing functions is to be outsourced, there are general provisions on outsourcing applicable in the majority of Member States. For instance, the creditor is expected to assess whether the firm to which it outsources fulfils fit-and-proper criteria and compliance with the most relevant rules applicable to them (anti-money laundering, customer protection regulations, etc.). The creditor remains liable for any breaches by the provider of outsourced services of any regulatory requirements in relation to the servicing of the loans (e.g. in IE, DK, NL). Furthermore, there are often minimum requirements in terms of risk management (e.g. in DE, IE, EE).

[146] Law 4354/2015.
[147] “Law On Extrajudicial Recovery of Debt” regulates the rights and duties of a creditor and a provider of debt recovery services in the field of debt recovery.
[148] The related law essentially covers notifying and collecting the amounts due and taking necessary steps to ensure payment of these
[149] Either the originator or an investor who have acquired the credit claim after inception

In EL, if the outsourcing creditor is not a supervised bank of financial institution, it can outsource only to a servicing company that is properly licensed and supervised by the Bank of Greece.

If outsourcing is deemed to affect core functions or services, it is not allowed or tied to strict requirements. For instance in DE, loan monitoring can only be subject to outsourcing if concrete criteria are defined for such activities; however credit decisions cannot be outsourced. In ES and MT, outsourcing of core activities requires authorisation by the competent authority. Some Member States do not allow to outsource refinancing, which is considered part of a credit/lending decision (e.g. in DE) or they require strict conditions to the outsourced institution (e.g. in RO).

As regards undertaking formal enforcement actions, in the large majority of Member States the creditor cannot outsource. Investor-linked servicers are not permitted to undertake formal enforcement actions on the creditor's behalf. In EL, however, loan servicers are entitled to all necessary legal remedies and can proceed to any other judicial action for the collection of the debts under their management.[150]

1.3.1.3 Potential requirements on the loan servicer

In the large majority of Member States, loan servicers are not legally required to comply with specific requirements. Loan servicers are in the vast majority of Member States neither required to obtain a full (except for SK, RO and NL in some cases) [151] nor a restricted banking license (except for HU and FR). In almost all cases, servicers do need to comply with certain fit-and-proper requirements. In IE and EL, servicers are required to comply with specific requirements and only entities that have an appropriate licence can conduct credit servicing. In LV, a provider of debt recovery services requires a special license. In the UK, the servicer of mortgage loans and consumer credit is required to meet some fit-and-proper criteria.[152] EL explicitly requires loan servicers to follow consumer protection including special care for the socially vulnerable groups.

Non-EU loan servicers are permitted in almost all Member States, except EL and they do not face additional requirements. In EL, non-EU loan servicers are not permitted and non-Greek EU loan servicers must act through a branch. Nonetheless, in AT, in case of pure outsourcing, stricter requirements can apply especially with regard to data

[150] Servicing companies will appear as non-beneficiary (third) parties in court proceedings and any relevant judgement shall be binding upon the lenders of the relevant loans.

[151] Servicing of a loan is considered as a banking activity. In fact, the bank that transferred the loan to a third-party is allowed to continue performing the servicing of the claim, if its banking license allows for the management of claims on behalf of clients, including advisory services. RO only regarding refinancing since it is considered lending activity.

[152] I.e. certain "fit and proper" criteria, specific form of incorporation, location of headquarters or incorporation, the ability to meet operational requirements and the ability to meet specific compliance and audit requirements.

protection issues, as the legal situation outside the EU is less harmonized. Whereas there are no explicit restrictions for non-EU loan servicers in SE, the supervision of the data protection authority may create a practical obstacle for some non-EU firms.

When a licensing/permit requirement exists on the part of the servicer, the exact criterion triggering the related procedure differs from one Member State to another. In IE, an authorisation is required when a firm is servicing loans on behalf of an unregulated entity. In EL licensing requirements differ between "simple" servicing companies and those that provide refinancing. In AT, factoring requires a licence, because the purchase and the acceptance of the risk associated with such receivables are decisive. In HU, the trigger is when a commercial activity is involved.

In Member States where third-party servicers need to go through a licensing process, the timeline differs from one country to another: 1 month in LV, 2 months in EL, ca. 3 months in AT, 5 to 6 months in HU. The UK has a statutory deadline of 12 months for deciding on submitted applications for regulatory permission. In IE, it is not possible to define timelines as yet, as the country's new authorisation regime was introduced only in July 2015.

Authorities that have the ability to grant licences to third-party servicers are the Member State's Central Bank (CY, HU, IE, EL), the Consumer Rights Protection Centre in the case of LV, the Financial Market Authority in AT, and the Financial Conduct Authority in the UK. In SE, the data protection authority also has a role.

The type of documentation required for any licensing application can be very diverse. This can entail generic information disclosure requirements (e.g. in CY, IE, LV, UK, HU), such as a description of the services, details of the service provider, the business plan, compliance plan, internal audit plan, specific conditions of the contract. EL prescribes a minimum capital paid in (EUR 100.000 for simple servicers and EUR 4.5 million for those that provide refinancing). On top of such general information, more details can be required about, for example, the amount of initial capital freely available (AT), or qualifying shareholder information (AT, IE). HU requires financial institutions applying for authorization to enclose (in addition to more general information): the proposed area of operations, a minimum amount of the initial capital for credit institutions. Furthermore, if the applicant is established abroad, a number of extra requirements are in place, e.g. a statement on having a main office in Hungary from which governance of the financial institution takes place.

1.3.2 Transfer of Loans

1.3.2.1 Civil law provisions on the transfer of loans

In principle, all Member States have at least one type of contract (either transfer of the credit rights or transfer of the loan contract) that allows the transfer of loan without the debtor's consent. Under the freedom of contract, debtor's consent can be either stipulated in the contract or exempted when it is required. When consent is required, it can be provided in standard forms and both in abstract at the time of the loan and at the time of the transfer (LT holds that consent in abstract would be legally problematic). Those

Member States that differentiate between the transfer of the credit rights (or receivables) and the more common transfer of the loan (or all the rights and obligations of the contract) require the debtor's consent for the latter (ES, PT, FR, IE, SI, AT, DE). As a rule, Member States would provide that the debtor shall enjoy the same legal position vis-à-vis the transferee of the loan than against the transferor. The only countries where debtor's consent is generally required by operation of law are SK and BE. Nonetheless, in SK, if the debtor has been more than 90 days in arrears (NPLs), consent is not required. In BE, if both assignor and assignee are financial institutions that transfer big portfolios of loans, debtor's consent will be overridden by an authorization from the competent authority. BG prohibits the transfer of consumer's credit loans unless already envisaged in the contract.

The collateral is generally transferred with the loan, thus it does not require a separate consent (SI requires consent when the collateral is in transferor's possession). There are no problems to transfer the loan when it is subject to enforcement actions (Only UK requires the court's approval). The transfer of NPLs to non-financial institutions is allowed in nearly all MS with the sole exception of CY that only permits to sell the loans to banks and financial institutions as eligible buyers).

The validity of the transfer of the loan seems to require notification in PT, CZ (when it is pledged), EE, BG, HU, SK, CY, FI, HR, IE (2 months in advance for loans that affect individuals and SMEs) and EL (the main terms must be registered with the competent Pledge Registry and following such registration, the borrower and, if applicable, any guarantor should be notified). In the rest of countries, notification is not mandatory, albeit the transfer of the loan does not produce effects against the debtor without it. The consequence would be that either the payment to the first creditor would discharge the borrower's debt or the transferees could not enforce their rights against the debtor. Therefore, debtor's notification is standard practice even in those MS where notification is not mandatory.

In general, the transfer of the collateral rights does not require a specific form. Nonetheless, if the collateral is registered because it is pledged or it is a mortgage loan, the transfer of the collateral in some MS requires access to the register as well (PT, IE, BG, DK). Other MS require the same specific form as the loan contract (SI, LV, LT). In some MS, there are ways to transfer the loan without a specific form, but the notarial certification and registration is either a general practice or it is required to have access and benefit from the previous registration (ES, FR, DE, CZ, BE, AT). Some MS declared that their laws do not require any specific form (UK, FI, SK, EE). In HU, there is not a specific form, unless the loan portfolio is above HUF 1bn.

1.3.2.2 Potential regulatory requirements and restrictions on the transferee/buyer

Although some countries require banking licenses when the loans are performing (FR, PT, SK, LT), NPLs are exempted. Nine Member States (HR, ES, FI, IE, DK, SK, PT, LT, UK) hold that the buyer of NPLs does not encounter additional regulatory constraints. Some additional specific requirements can be triggered depending on the type of loans (consumer credit or loans under a certain threshold) due to consumer protection provisions (SI, BE, SK, NL) or the nature of the activity (credit business or factoring) (DE, AT). Three Member States (BG, RO, EL) require fit and proper criteria, including a specific form of incorporation and the location of either head offices or a branch in the country. EL requires investors to sign a loan management agreement with a servicing company properly licensed and supervised by the Bank of Greece (see above). HU requires a restricted banking license and CY a full banking license. Thus potential licensing/permit requirement may be required because of the buyer's commercial activity in five Member States (DE, AT, EE, SK, BE). The type of loan could also trigger some specific requirements (SI, BE, SK, BG).

Non-EU institutions face the same requirements as EU-domiciled investors in the majority of MS. EL requires foreign firms to operate in the country through a local branch and neither being from a tax haven nor from a non-cooperating country.[153] Other exceptions are AT, HU, and BE (in case of companies domiciled in a tax haven), but they did not give further details in their reply.

1.3.2.3 Potential regulatory requirements on the transferor

Only three MS (BE, HR, LV) require authorisation on the transferor by the supervisor authority. Nonetheless, other countries require authorisation under some conditions (HU, DK, AT, LT) such as the volume of the deal (HU), competition law concerns (AT, LT) or both parties are financial institutions (DK). Getting approval from the supervisor, when required, lasts between one (LV) and six months (AT). Although Member States are not very concise about the requirements that trigger the authorisation, it is possible to identify transferees' book and market value (HU) and financial stability risks (HU and BE).

It is possible to identify other additional regulatory constraints on the transferor. First, IE requires a notification to the debtor two months in advance for some type of loans (natural persons and SMEs) due to provisions on consumer protection. Secondly, CY permits both the debtor and the guarantor to submit a proposal to purchase the loan 45 days after the notification. A third factor is data protection and bank secrecy as mentioned below.

[153] according to Greek tax law 4172/2013.

1.3.2.4. Role of investment funds to buy loans[154]

In most Member States, loans are eligible assets for alternative investment funds (in the meaning of AIFMD). In BG national investment funds cannot invest in NPLs, although AIF under the threshold of the AIFMD have no restrictions. In HU, loans are only eligible forms of investments if they are in the forms of derivative instruments and only UCITS are entitled to buy loan-based derivatives. There are special funds in SE that market shares to retail investors, which are not allowed to invest in loans.[155]

Both open-ended and closed-ended funds are authorised to buy loans with the exceptions of BE and FI where only closed-ended funds are entitled. In ES, closed-ended funds can invest in participative loans only under some conditions and up to certain thresholds. The particular legal forms of the funds are quite different in every Member State and they adapt to the different legal traditions.

It is common that only institutional/professional investors are permitted to invest in loan-participating funds. However some Member States entitle non-professional investors when they invest an amount above a certain threshold (€20.000 in LV, €100.000 in ES and CZK 1 million in CZ). Some Member States (ES, DK, DE) also extend this investment option to non-professional investors under strict conditions such as signature of risk knowledge or investment limits.

Managers of large alternative investment funds (in excess of AIFMD requirements) do not encounter specific minimum capital or other additional regulatory constraints, such as governance requirements, legal structures or restrictions to the outsourcing to third-party servicers in most Member States. However, PT imposes some fit and proper criteria on managers and it requires some legal corporate structure to the funds such as a management body, a supervisory body and an external auditor. Managers and funds in ES and DE shall comply with some governance requirements and investor protection regulations if they want to become entities supervised by the competent authority and enjoy tax advantages. In all Member States, the relevant investment funds are supervised by either the financial supervisory authorities or Central Banks.

Lastly, although there are some differences across the EU, the timeline for the authorisation or registration process of the relevant investment funds lasts between 20 working days and 6 months depending on the type of fund. In addition, most Member States did not report any specific tax provisions in place which may restrict and/or

[154] A number of Member States (MT, UK, SK) did not submit any answer to the questions related to the role of investment funds to buy loans.

[155] These are AIF with permission from the Swedish FSA under the national regime to market shares to retail investors.

disincentive the transfer/sale of loans as long as funds engage in pure investment activities (in contrast to commercial activities).

1.3.3 Data protection and bank secrecy provisions

Another common pattern in Member States' replies is that the bank remains responsible vis-à-vis the client for the treatment of the data when it outsources some activities to a servicer. The Member States which are more specific on this hold that the creditor, in most cases the originating bank, has to sign an agreement with the servicer that regulates the use of personal data. The servicer shall not use the personal data for other purposes than those established in such agreement. On the other hand, if the bank transfers the loan and deletes all personal data, it is not responsible vis-à-vis the client anymore (ES, FR, IE, AT, HU, FI, BE). Some MS hold that the bank retains responsibility when it transfers the loan to entities which are not subject to bank secrecy (CZ, MT SK and LT). Three MS (PT, SI and EE) only mention that the transferor retains responsibility vis-à-vis the client but they do not specify how.

Bank secrecy provisions generally contain an exemption that allows the bank to disclose data which are necessary and proportionate for selling the loan. In the case that the debtor gave consent, which seems to be a general practice, the bank would have more leeway to disclose personal data. This exception is explicit in HR and HU for the selling of receivables. Other Member States hold that the disclosure of debtor's protected information can in certain cases be considered as a legitimate interest of the transferor, which would be an exemption to bank secrecy provisions according to their national law (ES, FR, IE, RO, SI, DK, CY, FI, BE, MT, CZ). The strictest regimes appear to be in BG and AT where the transfer of confidential data is only allowed under the debtor's consent or an authority's decision.

It seems to be standard practice in most of MS that the seller describes the loan without disclosing confidential and personal data in the initial transaction phase and may only disseminate such information in a second stage or when the contract has been concluded. Those who have access to confidential information must keep it confidential.

2. OBSTACLES FLAGGED IN THE PUBLIC CONSULTATION

The public consultation preceding this impact assessment asked stakeholders to identify obstacles to the development of secondary markets and to communicate their assessment of the obstacles' importance to marekt development. This annex provides an overview of the main obstacles emerging from the consultation responses. Following are the main obstacles that came out of the consultation, organized around four main pillars: data quality and availability; legal system & collateral enforcement; costs of entry & asset transfers; and recovery expectations & disposal losses.

Table A6.1. Obstacles to the development of secondary market for NPLs

A. Data quality & availability	B. Legal system & collateral enforcement	C. Costs of entry & asset transfers	D. Recovery expectations & disposal losses
Banking secrecy	Ability to obtain stay on enforcement	Licensing requirements for investors & services	Collateral valuation gap
Consumer privacy	Right to settle at transfer price	Cross-border authorizations (non-EU)	Regulatory approach on provisioning
Standardization of data	Efficiency of out-of-court mechanism	Taxes & other costs due to transfers	Tax disincentives on provisioning
	Cross-border differences in collateral enforcement	Economic conditions	Impact on disposal losses on regulatory capital
	Cross-border differences in dunning process	Social & political resistence to collateral enforcement	
	Judicial & operational capacity		

Source: EC Consultation Responses

2.1 Data quality & availability

The unavailability of high quality data has been picked as the main obstacle to the development of secondary NPL markets by most respondents. The inability of a prospective buyer to discern the quality of the assets, which is intrinsically known to the seller, leads to an outcome where only the low quality assets, or "lemons", are traded.[156] These information asymmetries lower bid prices, obstruct the price discovery process, and may even impede altogether the development of a secondary market. To overcome these challenges, prospective investors typically conduct a detailed review of the relevant

[156] See G. Akerlof (1970) "The market for "lemons": quality uncertainty and the market mechanism", *Quarterly Journal of Economics*, Vol 84, No. 3, pp 488-500.

portfolio prior to making an offer for the for-sale portfolio. Ideally, the analysis should be similar to the credit risk and recovery assessments made by the banks originating the loans, involving the assessment of the expected future cash flows, collateral realization and costs related to servicing, selling, or enforcing the contract. Such an analysis is usually hampered when investors lack access to data on payment histories, recovery rates, or collateral valuations on comparable exposures.

Banking secrecy and consumer privacy issues are identified as the main reason for the limited flow of information to buyers. As highlighted by one respondent, the need to overcome the inherent information asymmetries has to be balanced with privacy concerns. In many jurisdictions[157], banking secrecy rules prevent banks or other entities managing credit exposures to disclose client-specific information to third-parties. This effectively prevents the transfer of loan-specific data prior to a sale, unless valid client consent is available, even when the loan is non-performing. The transfer of the portfolio to another entity, such as securitization special purpose vehicles (SSPVs) or external servicers, to conduct the pre-sale due diligence on behalf of the investors to circumvent these rules against divulging client-specific information is deemed too costly, further adding to the bid-ask spread.

The uniformity of the data on the NPLs and the underlying collateral are also identified as an obstacle undermining general data quality. In some countries, banks cannot transfer data outside the country, inhibit cross-border entry. Similarly, the non-uniform nature of loan-level data on NPLs and legal documentations limit the gains from economies of scale that would be available to international players. Several participants welcome the renewed focus on achieving data uniformity at the EU level, but point at areas that have not received adequate attention.[158] For example, a number of respondents identify the lack of comparable, reliable and granular information on real estate market transactions as a major shortfall, rendering benchmark comparisons difficult.

2.2 Legal system & collateral enforcement

Most respondents identified lengthy and onerous legal procedures for enforcing loans as a key obstacle to the development of NPL secondary markets. Lengthy and costly enforcement procedures introduce legal uncertainty and lower the net present value of the expected recovery proceeds, thereby driving up the bid-ask spread. Several respondents highlighted that a major issue was the ability of borrowers to oppose and

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157 According to evidence from the consultation responses, banking secrecy rules prohibit the transfer of information prior to a sale of loans in Austria, Cyprus, Denmark, France, and Portugal. In Czech Republic, Germany, Hungary, and Poland banking secrecy rules do not apply for non-performing loans.

158 More recently, in its July 2017 action plan to tackle non-performing loans in Europe, the European Council has invited the EBA, ECB, and the European Commission to propose by end-2017 initiatives to strengthen the data infrastructure with uniform and standardised data for NPLs and consider the setting-up of NPL transaction platforms. In line with this call, EBA has recently developed NPL templates to take into account different data needs of potential NPL investors. ECB has also worked on a broader loan-level data reporting project, which was adopted by the ECB Governing Council in May 2016, to collect granular loan-level data (AnaCredit) for all loans to legal entities and establish a shared database for the European System of Central Banks (ESCB) starting with September 2018.

obtain stay on legal enforcement actions.[159] Lengthy enforcement procedures also increase the risk that the collateral may deteriorate in value, particularly for loans backed by industrial plants or industrial warehouses. Borrowers whose loans were sold have the right to settle their loans at the price of assignment, without distinguishing whether the loan is performing or non-performing.[160] In addition to unlocking NPL sales, addressing these issues can also lower strategic defaults and incentivize borrowers to engage voluntarily with creditors.

The efficiency of out-of-court procedures is also partly dependent on the ability of creditors to enforce the collateral. If creditors can foreclose the collateral with relative speed and reasonable costs, this can also incentivize borrowers to lower negotiate with the creditor voluntarily, as in the case of out-of-court procedures. In many countries, the out-of-court enforcements or sales, much like their legal counterparts, involve lengthy notification periods. More importantly, in many member states[161] debtors have the ability to stall the process through legal action, which was identified as a main reason lowering the use of out-of-court sales in Spain. One respondent highlighted that out-of-court financial collateral agreements are made difficult as the borrowers have the ability to request, and re-request) valuations by third parties.

Several respondents also noted that there are severe cross-border differences in the legal procedures and their application. In particular, differences over the application of legal foreclosures, insolvency procedures, consumer protection laws, as well as out-of-court procedures constrain the gains from economies of scale for larger international investors. National differences and legal impediments over the dunning process (i.e. methodical communication with borrowers to ensure the collection of accounts receivable) are also reported. The respondents also note that there are legal impediments to access of the creditors to contact data of the debtors for non-creditors. As a whole, these procedural differences make it difficult for cross-border investors and services to automate and standardize the maintenance of NPLs.

The improvement of judicial and operational capacity could help improve recovery expectations in certain regions. Small claims courts do not exist in some member states, which undermines efficiency of the legal procedures for credit recovery and lengthening the collection term and cost. The length of bankruptcy proceedings in certain member states[162] vary substantially depending on the assigned court, which are perceived

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159 The issue of debtor protection in the case of NPLs was identified as a major impediment to the further development of NPL secondary sales in Italy. In France, borrowers can insert terms to limit the transferability of their debt at the time of origination. In Cyprus and Greece, transfer of loans may require the explicit consent of the borrower, even in the case of non-performing loans. In many jurisdictions, including most notably France, Cyprus, Ireland, Italy, and Spain, borrowers have the ability to launch appeals, stays, or suspended evictions, in the event of any legal dispute.

160 Although, these practices aim to protect borrowers and avoid litigious claims in the case of sale of performing loans, they severely undermine investor interest in the case of non-performing loans, effectively limiting any potential benefits. In Spain, such provisions appear to exist in Navarra and Cataluña (for residential properties), although their legality has been challenged.

161 According to evidence form the consultation responses pledgees have the ability to stall collateral repossessions in Italy and various Spanish regions.

162 Respondents to the consultation identified Ireland, Italy and Portugal as countries where the length of bankruptcy proceedings varies substantially.

to be due to differences in the capacity of those courts in dealing with NPL resolutions. In addition, property appraisals conducted in the context of secured NPL securitisations are characterised by high levels of uncertainty. Valuation uncertainty is driven partly by the illiquid nature of the assets securing the loans. This uncertainty is exacerbated by lengthy recovery procedures.

2.3 Costs of entry & asset transfers

Specific entry barriers and the inability of certain investors to purchase assets have also been identified as important obstacles to the development of secondary markets. To that extent, certain jurisdictions allow a sale of NPLs only if the investors are financial entities or even banks, which inhibit entry from a wider spectrum of investors.[163] NPL transfers may also be subject to specific authorization requirements and approvals of local authorities in the case where foreign entities are involved, which increased transaction costs. These restrictions are at times more poignant for foreign, in particular non-EU, investors.[164] As noted above, in some jurisdictions the consent of the debtor may also be sought prior to the transfer of assets. These restrictions are particularly present for the transfer of retail NPLs. The presence of entry barriers and transfer restrictions may impede investor interest and, at best, focus investors' interest in sufficiently large markets where they may reap net benefits from obtaining the required licenses and authorization.

In addition to licensing and authorization requirements, taxes on loan transfers have been identified as a second impediment to the development of the secondary NPL markets. There are a number of tax contingencies that may arise from the transfer of loans. First, losses on asset disposals may not be tax deductible for the originating bank and may give rise to taxable income for debtors.[165] Second, in some countries asset transfers may give rise to withholding taxes on interest income, stamp duties, or other administrative costs, such as notarial costs and collateral registration fees.[166]

A number of respondents also highlight that local social, political and economic conditions may also be important determinants of entry decisions for investors. The underlying economic conditions are clearly an important factor for the expected value of the NPLs. A lower unemployment rate and higher growth rate have a positive impact on

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163 In certain jurisdictions, only entities holding banking licenses are allowed to buy NPLs, including Cyprus, Slovenia (for consumer loans), and Germany (where further loan drawings may be involved). In others, like Spain (for mortgage loans) and Hungary, only financial entities are allowed to buy NPLs. In Italy, investors are able to invest in NPL portfolios only through a local SPV supervised by the national authority. In Romania, investors have to be authorized by the domestic Consumer Protection Authority.

164 In Germany, non-EU investors investing in NPL are required to establish a local German servicing enterprise. One respondent complained that non-EU entities may face substantial difficulty in Hungary to obtain local licenses and authorizations for managing NPLs, including banking license and tax exemptions.

165 In Poland, disposal losses are tax deductible only if the relevant NPLs were enforced (i.e. foreclosures) or if debtor was declared insolvent.

166 In Spain, stamp duties (*Actos Jurídicos Documentados*) and other administrative costs (i.e. notary and registry fees) are seen by several respondents as the main obstacle to the development of secondary market transactions.

cure rates, effectively increasing the expected returns for investors. Political conditions can be determinant in two distinct ways. First, much like macro-economic conditions, political stability can help ensure high future returns. Second, and perhaps more importantly, collateral enforcement may be made difficult due to political and social atmosphere. This is especially the case in countries enforcing loan contracts are seen as putting people out of their homes, i.e. where retail mortgage NPLs are concerned, and where there is a public perception of unfair practices or financial misconduct by banks. To that extent, certain investors may be concerned with reputational risks arising from the use of recovery procedures, including foreclosures or more intrusive collection practices. Conversely, originating banks may also perceive NPL disposal harmful on their existing relationships with their customers.[167]

The cost and availability of loan servicers has been identified amongst the entry obstacles most participants. Third-party services represent an alternative for buyers of NPLs to manage the loans and client relations. Having a third-party servicer also allows the investors to sell the assets to other investors in the future, effectively providing them an outside option. However, in some jurisdictions the servicers have to be licensed and possibly supervised, much like the investors.[168] As another key complaint, several respondents noted that these requirements, apart from being onerous, differed substantially, undermining the economies of scale advantages that many international services rely on. Despite these concerns, however, several respondents note that debt servicers are becoming more common-place across the EU, especially over the last two years, embracing new asset classes.

2.4 Recovery expectations and disposal losses

Higher recovery expectations of the originating bank is seen by several respondents as the main cause of a high ask price in the context of NPL sales. It is quite common that buyer and sellers have different valuations of the underlying assets, especially in the case of NPLs where data quality and availability issues may exist (see above). However, valuation gaps may exist even in the absence of those issues. For example, the buyers and the sellers may have different discount rates to discount the future cash flows, effectively widening the bid-ask spread especially in countries where recoveries take substantial amount of time. As another example, investors and originating lenders may have different stances in assessing recoveries. Investors often aim to conduct a detailed and "dispassionate assessment" of the expected recovery, relying exclusively on recent collateral valuations, payment histories of lenders, and other forms of verifiable data on expected future cash flows. Originating lenders, on the other hand, may conduct a more subjective assessment, possibly due to the presence of "endowment biases", blending in their current financial positions (i.e. the ability to absorb losses) or any past/future commercial relationship with the borrower.

[167] One respondent noted that there is a general negative public conception of and campaigns against servicers and debt collection agencies (the DCAs), especially in some central Eastern European countries.

[168] According to consultation responses, third-party servicers have to have specific licenses in Germany, Greece, Slovakia, and supervised in Romania.

Losses form NPL sales were also seen as a key obstacle to the development of NPL markets. Disposals can lead to losses due to several reasons. First, and foremost, disposing assets that are not adequately provisioned leads to financial losses, especially when market conditions are depressed. Apart from the subjective assessments mentioned above, under-provisioning may also arise due to regulatory or fiscal disincentives (i.e. non-deductibility of provisioning losses). Forbearance rules may also allow banks to graduate NPLs to performing status, even on a temporary basis, circumventing the need to provision more. As a second manner in which disposals may generate losses, banks using advanced internal ratings-based (A-IRB) models may suffer from higher capital requirements in the future as the losses appear in their historical data sheets.[169] Lastly, heightened preference for an accelerated NPL reduction may flood the market with similar types of assets and lead to fire sales.

Appendix to Annex 6

6.A.1 IMF and ECB/SSM Surveys about the legal framework of NPL markets in the EU

A.1 IMF survey of country authorities and banks 2015

In 2015, the IMF (2015a, b) conducted a survey among 19 country authorities as well as 10 banks operating in these countries about institutional obstacles related to (1) the supervisory framework, (2) the legal system, (3) distressed debt markets, (4) informational shortcomings, and (5) the tax regime. At the request of country authorities, the individual country replies were not revealed, i.e. the table below does not display which country gave which rating.[170] While the responses reveal a considerable variation, the concerns were on average somewhat more severe with respect to the legal framework and distressed debt market than for other issues addressed by the NPL Action Plan. While the questions on the legal framework were related to insolvency procedures and enforcement of NPLs[171], the issues identified with market development related to:

(1) incomplete credit information on borrowers;

(2) lack of licensing and regulatory regimes to enable nonbanks to own and manage NPLs;

(3) overvalued collateral and lack of liquid real estate markets;

169 These concerns were raised in particular in the context of Italian and Romanian banking systems.

170 The survey was completed by 10 banking groups (Alpha Bank, Intesa, NBG, Piraeus, Pro Credit, Raiffeisen, Societe Generale, Unicredit, Eurobank, and Erste Group) and 19 countries, of which 9 euro-area Members States (Cyprus, Greece, Ireland, Italy, Latvia, Lithuania, Portugal, Slovenia, and Spain), 3 non-euro area Member States (Croatia, Hungary, Romania) and 7 non-EU countries (Albania, Bosnia and Herzegovina (from two separate jurisdictions), Iceland Macedonia, Montenegro, San Marino, and Serbia).

171 IMF (2015a), technical background paper reports a high correlation of the results of the survey with respect to legal obstacles and the World Bank Doing Business indicators on the insolvency frameworks and contract enforcement.

(4) low recovery values, partly related to lengthy court procedures; and

(5) inadequate provisioning of NPLs.

Overall, the IMF survey suggests that potential buyers of NPL face relatively few explicit restrictions. Most countries allow that third-party (including foreign) banks, as well as institutional investors buy NPLs from local banks. The survey responses also document that obstacles to market entry existed in some Member States still in 2015 (see Figure 6), though some conditions have changed in a few Member States since then, most obviously with respect to the activity of loan servicing firms.

Table A6.A1 IMF assessment of determinants of NPLs in EU Member States

Institutional Obstacles Scores

Countries	Information	Supervisory framework	Tax regime	Legal framework	Distressed debt market	Composite score
EA	2.6	2.5	3.0	3.0	3.0	2.8
NEA	2.0	2.3	1.6	2.5	3.0	2.3
NEA	1.8	2.0	2.8	2.1	2.7	2.3
EA	2.4	1.8	2.0	2.4	2.7	2.3
NEA	1.7	2.3	2.0	2.0	3.0	2.2
NEA	1.8	1.8	2.0	2.3	3.0	2.2
NEA	1.8	1.8	2.0	2.1	3.0	2.1
NEA	2.0	1.5	1.8	3.0	2.0	2.1
NEA	1.3	1.5	2.0	2.0	3.0	2.0
EA	2.2	2.0	1.0	2.5	2.0	1.9
NEA	1.8	1.3	2.0	2.0	2.5	1.9
NEA	1.8	1.5	2.3	2.0	2.0	1.9
EA	1.4	1.8	1.0	2.3	3.0	1.9
NEA	2.0	2.0	1.2	1.7	2.0	1.8
EA	1.8	2.0	1.3	1.4	2.0	1.7
NEA	1.8	1.5	2.0	1.7	1.0	1.6
EA	1.8	1.5	2.0	1.7	1.0	1.6
EA	1.0	1.3	2.0	2.0	1.0	1.5
EA	1.2	2.0	1.0	1.0	2.0	1.4
EA	1.0	1.0	1.0	1.0	1.0	1.0
Avg	1.8	1.8	1.8	2.0	2.2	

Source: IMF surveys of country authorities and banks.

Notes: EA = euro area country; NEA = non–euro area country. "Country survey" refers to the survey of country authorities and "bank survey" refers to the survey of banking groups with operation in the countries included in the country survey; 3 = high degree of concern, 2 = medium degree of concern; 1 = no concern; "gray" =unknown or missing responses. The scores shown in the figure are Max (country, bank), that is, max score from country and bank survey. For each country, composite score is a simple average of obstacle scores in each of the five areas (information, supervisory framework, tax regime, legal framework, and distressed debt market). See Background Notes, Section VI, for details.

Table A6.A2 IMF assessment of determinants of NPL markets in EU Member States

	All countries			Euro area countries			Non-euro area countries		
	NO	YES	N.A.	NO	YES	N.A.	NO	YES	N.A.
1. MARKET FOR NPLs/DISTRESSED DEBT									
Are third party banks, including foreign banks, allowed to buy NPLs from domestic banks?	10	85	5	22	67	11	9	91	0
Are institutional investors allowed to buy NPLs from domestic banks?	10	75	15	33	56	11	0	82	18
Are foreign institutional investors allowed to buy/own NPLs?	20	70	10	33	56	11	18	73	9
Do special servicing firms operate in the country?	25	60	15	33	56	11	27	55	18
Can banks sell denounced loans (i.e., legally and economically written off)?	15	75	10	22	56	22	18	82	0
Can banks set up private asset management companies in cooperation with investment firms?	5	85	10	11	78	11	9	82	9

6.A.2 ECB/SSM Stocktake 2017

The ECB Banking supervision's (SSM) "*Stocktake of national supervisory practices and legal frameworks related to NPLs*" collected data from national competent authorities of the 19 euro area MS in December 2016. The survey indicates that the regulatory framework in all participating countries allows banks to outsource NPL loan servicing activities, although this practice remains uncommon in many Member States. The Stocktake also shows that legal and regulatory frameworks present a favourable environment for NPL transfer and the entry of specialised investors into the local market. The few countries that had legal impediments, such as portfolio transfer restrictions on non-banking institutions or barriers to the entry of foreign investors, have amended their regulatory frameworks.

Table A6.A3 SSM assessment of loan servicing rules in euro area Member States

The regulatory framework allows:	CY	GR	IE	IT	PT	SI	ES
banks to outsource NPL management	✓	✓	✓	✓	✓	✓	✓
non-banks to manage NPLs	×[1]	✓	✓	✓	✓	✓	✓

The regulatory framework allows:	AT	BE	DE	EE	FI	FR	LV	LT	LU	MT	NL	SK
banks to outsource NPL management	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
non-banks to manage NPLs	×[2]	✓	✓	✓	✓	✓	✓	✓	×[1]	✓	✓	✓

1) possible under certain conditions
2) non-banks are allowed to purchase and sell off loans but not manage them

Table A6.A4 SSM assessment of rules applying to the Sale of loan portfolios in euro area Member States

Main features of the sale of portfolios

Jurisdictions with high NPL levels

	CY	GR	IE	IT	PT	SI	ES
Existence of a developed NPL market?	No	No	Medium	No	No	No	Medium
Does an AMC exist?	No	No	Yes	No	No	Yes	Yes
Transfer of loans (and collateral) without borrower's consent?	Yes	Yes[1]	Yes	Yes	Yes	Yes	Yes
Banks are allowed to sell NPLs to third parties							
to non-banking institutions	Yes[2]	Yes[1]	Yes	Yes	Yes	Yes	Yes
to foreign investors	Yes[2]	Yes[1]	Yes	Yes	Yes	Yes	Yes

Jurisdictions with low NPL levels

	AT	BE	DE	EE	FI	FR	LV	LT	LU	MT	NL	SK
Existence of a developed NPL market?	No	No	No	No	No	No	No	No	No	No	No	No
Does an AMC exist?	No	No	No	No	No	No	No	No	No	No	No	No
Transfer of loans (and collateral) without borrower's consent?	Yes	Yes[5]	Yes	Yes	Yes	Yes	Yes	Yes	Yes[4]	Yes	Yes	Yes
Banks are allowed to sell NPLs to third parties												
to non-banking institutions	Yes	Yes	Yes	Yes	Yes	Yes[3]	Yes	Yes	Yes	Yes	Yes	Yes
to foreign investors	Yes	Yes	Yes	Yes	Yes	Yes[3]	Yes	Yes	Yes	Yes	Yes	Yes

1) changes have been implemented in the first half of 2016
2) possible under strict conditions
3) restricted to EEA countries only
4) in some cases, the debtor may have to agree to such a transfer
5) provided there is an explicit provision allowing the transfer in the loan documentation

6.A.3. Authorisation rules for Loan servicers and NPL purchasers in the EU Member States

Information provided by Member States in summer 2017 unless otherwise indicated

	Loan servicers	NPL purchasers
BE	There is no direct supervision by the Belgian prudential supervisor towards the servicer. The necessity to comply with certain specific requirements is however organized indirectly, through the supervised institution, which remains fully responsible for the outsourced services and activities, and which will therefore itself take all necessary measures to supervise the activities provided by the external servicer (and, e.g. its ability to meet operational requirements and specific compliance and audit requirements, cf. article 66 of the Banking Law).	The answer depends on the nature of the acquired loans. With respect to the transfer of consumer credits, article VII.102 of the Code of Economic Law confirms that « The agreement or the receivables resulting from the credit agreement can only be assigned to, or, after substitution, only be acquired by a creditor licensed or registered in application of this Book, or can be transferred to or acquired by the National Bank of Belgium, the Protection Fund for Deposits and Financial instruments, credit insurers , institutions for investment in receivables within the meaning of the Law of 3 August 2012 on undertakings for collective investment which satisfy the conditions laid down in Directive 2009/65/EC and institutions for investments in receivables, or other persons specifically designated to that purpose by the King". The "creditors licensed or registered in application of this Book" are creditors of consumer credits and creditors of mortgage loans (both licenses to be issued by the FSMA). No other institutions or persons were specifically designated by Royal decree so far. With respect to the transfer of mortgage credits, article VII.147/17 of the Code of Economic Law confirms that: "Without prejudice to the application of articles 1250 and 1251 of the Civil Code, a mortgage credit with movable use (e.g. to acquire a vehicule) or the receivable resulting from such credit agreement can only be assigned to, or, after substitution, only be acquired by a creditor licensed or registered in application of this Book, or can be transferred to or acquired by the National Bank of Belgium, the Protection Fund for Deposits and Financial instruments, credit insurers, institutions for investment in receivables within the meaning of article 2 of the Law of 3 August 2012 on various measures to facilitate the mobilization of receivables in the financial sector, or other persons specifically designated to that purpose by the King". The "creditors licensed or registered in application of this Book" are creditors of consumer credits and creditors of mortgage loans (both licenses to be issued by the FSMA). No other institutions or persons were specifically designated by Royal decree so far.
BG	None	If the activity of acquiring loans represents 30% and

	Loan servicers	NPL purchasers
		more of the activity of the buyer and it is by occupation, a registration into a public register of the BNB is required under art. 3a of Law on credit institutions. The legislation determines requirements about the qualification, experience and reputation of the managers and qualifying shareholders. The minimum threshold of the registered capital and the equity of the financial institution shall be maintained above BGN 1 000 000 (500 000 EUR) on an ongoing basis. The origin of the capital funds shall be legitimate and transparent The BNB does not apply prudential supervision for the financial institutions. form of incorporation – Ltd, JSC, location of headquarters or incorporation in BG, ability to meet certain compliance
CZ	none	none
DK	The servicer is not required to obtain a full or restricted banking license. The servicer is furthermore not required to meet any "fit and proper" requirements.	A buyer of a loan or a portfolio of loans is not required to obtain a full or restricted banking license or required to meet any "fit and proper" requirements. If the buyer is not already registered according to the AML regulation in Denmark, registration according to this is a requirement
DE	Based on Art. 25a KWG and MaRisk (AT 9), the service provider has to provide sufficient resources and expertise to perform the outsourced activities and processes in an appropriate manner.	The purchase of loan receivables in execution of a sales contract does not constitute credit business in the meaning of § 1 According to the constant administrative practice of BaFin the contractual transference of the loan relationship between originator and borrower on the credit buyer and borrower (only possible with the approval of the borrower) in execution of the sale contract isn't looked as loan business. Both activities are usually considered as "factoring", thus, an activity requiring a license. However, the license requirement is only triggered when there is a framework agreement between the seller (bank) and the purchaser (factoring company) - aside from the concrete sale of claims. The framework agreement does not have to exist in written form. In the case of a transfer of individual NPL portfolios (without a framework agreement) to investors or servicers, the German Financial Supervisory Authority (BaFin) decides on a case-by-case basis whether it considers the activity in question to be "factoring" requiring a banking license.
EE	none	commercial activity is the criterion for triggering the possible licensing/permit requirement
IE	the servicer is required to comply with specific requirements to legally perform the activities. Under the Consumer Protection (Regulation of Credit Servicing Firms) Act 2015 which was enacted on 8 July 2015 only entities that have an appropriate licence can conduct credit servicing. This legislation was brought in to ensure that borrowers whose loans were sold by a regulated lender to an unregulated entity maintained the same level of protection as they had prior to the sale of the loan. Under the legislation the unregulated loan owner is required to appoint an authorised credit servicing	There are no licensing or regulatory requirements in relation to the acquisition and holding of a loan portfolio. However, depending on the nature of the loans, the transferee may be required to: be authorised as credit servicing firm to service the loans itself; or appoint an authorised credit servicing firm to service the loans on its behalf.

	Loan servicers	NPL purchasers
	firm to service the loan portfolio. Entities that provide credit servicing include: 1. An entity that holds a licence to grant credit, i.e. a licensed bank, retail credit firm or moneylender; and 2. An authorised Credit Servicing Firm Pre-Approval Control functions have to go through the fitness and probity regime by submitting an Individual Questionnaire. The firm is to be incorporated in the State. The legislation also allows them to set up a branch in the State also, for example, if a firm is based in the UK, the firm can then set up a branch in Ireland.	
EL	- ability to meet specific compliance and audit requirements - other The servicing companies are required to comply with the following requirements: • They are Greek companies under the legal form of Société Anonyme or companies established in any other EEA (European Economic Area) Member-state which operate in Greece through a branch • Their scope of activity must be limited specifically and explicitly to servicing of loans • They must be granted a special operating license for the above purpose by the Bank of Greece, which also remains the sole competent authority exercising supervision throughout their active operating status • They are registered in the General Commercial Registry (G.E.MH.) • Their license is published in the Governmental Gazette. The Bank of Greece Executive Committee Act No 118/19.5.2016 specifies the criteria, conditions and supporting documentation with respect to the licensing procedure for the establishment and operation of the servicing companies. According to the above mentioned Act, the servicing companies are distinguished into two different categories: the “simple” servicing companies and the ones that are authorized to provide refinancing. For the refinancing servicing companies the requirements are the same as other financial institutions operating in Greece, i.e. leasing, factoring and consumer credit companies. More specifically, it is required that these companies need to comply with the fit and proper requirements for their management body members and for their shareholders, with governance requirements equivalent to banks and initial capital of four million five hundred thousand euro (€4,500,000). The “simple” servicing companies have less requirements such as a lighter fit and proper framework and a few governance requirements such as a written policy to prevent conflicts of interest and initial capital of one hundred thousand euro (€100,000).	According to law 4354/2015 (article 1, par.1b), the following requirements apply to the buyer (Loan Transferring Companies) : • They are Greek companies under the legal form of Société Anonyme or companies established in any other EEA (European Economic Area) Member-state or companies domiciled in third countries, which may at their discretion operate in Greece through a branch, provided that they are not domiciled in countries with “favourable” tax regimes or “non-cooperating” according to Greek tax law 4172/2013. • Their scope of activity must explicitly include the acquisition of loans and credit. They are capable of loan/credit acquisitions only under the condition that they have signed a loan management agreement with a servicing company properly licensed and supervised by the Bank of Greece. Loan Transferring Companies themselves are not required to obtain any operating license.

	Loan servicers	NPL purchasers
	All companies should be AML compliant and have a detailed report setting out the basic principles and methods ensuring the success of forbearance/restructuring solutions; such report shall not be required where the firm carries out servicing business on behalf of a credit or financial institution supervised by the Bank of Greece that is primarily obliged to meet this requirement.	
ES	The servicer is not legally required to comply with specific requirements, as there are no specific regulations on the servicing activity. Whether the outsourcing is deemed to affect core functions or services, credit institutions shall formally notify the competent authority, at least one month in advance, of their plans to delegate those functions or services. This notification shall be accompanied by the related analysis of risks and of the mitigating measures. The competent authority, depending on the nature or criticality of certain functions or activities, may establish additional limitations on the delegation.	none
FR	Les exigences dépendront du caractère échu ou non de la créance et du caractère amiable ou contentieux du recouvrement (étant entendu que le recouvrement forcé ne peut porter que sur créance liquide ou exigible et ne peut se faire que sur la base d'un titre exécutoire dont la délivrance constitue le préalable). Restricted baking license: pour les sociétés de financement qui ont été agréées pour réaliser des opérations d'affacturage (étant entendu que les autres entités autorisées à réaliser des opérations de crédit sont soumises aux règles qui leurs sont propres).	Dans le cas de créances non échues, l'acquéreur exerce une activité réglementée et doit donc avoir été autorisé dans les conditions suivantes : - banking licence, meet certain "fit and proper" criteria, specific form of incorporation, location of headquarters or incorporation, ability to meet operational requirements, ability to meet certain compliance and audit requirements, accounting requirements (i.e. do buyers have to comply with IFRS or national GAAP provisions?)
IT[172]	debt collection license held with police office	Non-banks should fulfil simplified capital requirements. An investor needs to partner with a local management company in order to comply with national regulation, the securitization law strictly requires the establishment of a local SPV
HR	there are no specific regulation that regulates loan servicers.	there are no requirements for the buyer.
CY	There is no specific requirement for the servicer. For outsourcing applications (the bank will outsource the servicing of loans to a third party) the following are required: - Description of the services - Details of the provider (in this case the servicer) - A risk assessment by the bank that has to carry out for the tasks will outsource Specific conditions of the contract	According to the Law regulating the Sale of Credit Facilities and Other Related Issues, only the following legal persons are allowed to acquire credit facilities that are less than 1 mln: (A) A credit acquiring company, including an asset management company, incorporated in the Republic, which has obtained authorisation from the Central Bank. In order to obtain authorisation, the company must submit information to the Central Bank demonstrating amongst others, that it fulfils certain

[172] Information from industry source in public consultation.

	Loan servicers	NPL purchasers
		"fit and proper" criteria, operational and organisational requirements and any other information as deemed necessary by the Central Bank which are reflected in the Law. (B) An authorised credit institution (C) A credit institution that is authorised and supervised by the competent authority of another member state, which has the right, by virtue of section 10A of the Business of Credit Institutions Law, to provide services or to establish a branch in the Republic. (D) A financial institution, which is a subsidiary of a credit institution incorporated in a member state and which provides its services in the Republic or operates in the Republic through a branch, under the provisions laid down in section 10Bbis of the Business of Credit Institutions Law.
HU	restricted banking licence, specific form of incorporation, -ability to meet specific compliance and audit requirements, trigger is commercial activity	restricted banking licence, specific form of incorporation, -ability to meet specific compliance and audit requirements
MT	Third party service permits are not known to exist. BR/14 requires that if the service being outsourced is lending, a banking licence is required	a buyer of a loan is expected to be authorised by the Authority to carry out the activity of lending under the Financial Institution's Act and/or the Banking Act [banking rule BR/14 principle 4.1]
LU[173]	There is a licensing and regulatory regime in place to enable non-banks to recover/manage debts (including NPLs)	
LT	no special requirements. General contract law provisions shall be applied	No specific requirements are needed for a buyer acquiring a defaulted loan where the contract agreement is terminated; In case of performing household loans (either unsecured or secured), the acquirer must have a licence of a credit provider, i.e. a consumer credit provider licence, a banking licence or a restricted banking licence. In case of performing corporate loans, no specific requirements are in place.
LV	A provider of debt recovery services is entitled to recover a debt in the name of or on behalf of a creditor, if it has registered as a merchant or a performer of professional activities and has received a special permit (licence) for debt recovery. The Consumer Rights Protection Centre shall issue the special permit (licence).	The Civil Law does not regulate such matters. Only general provisions for different kind of contracts are included in the Civil Law which are applicable to any contractual party.
NL	In the Act on Financial Supervision (Wet op het financieel toezicht (Wft)) there is a duty for companies to have a licence from the Authority of Financial Markets (AFM) or a waiver, if they act as an agent in the establishment of (loan) agreements	There is a duty for companies to have a license if they offer credit. In case of a transfer of a loan, the new owner is the one who 'offers' the credit. In such a case a license is needed. There are however waivers, such as for Special Purpose Vehicles (SPVs). In that case the new owner has outsourced

173 ECB/SSM (2017)

	Loan servicers	NPL purchasers
	between lenders and consumers In some cases debt collectors need a license (to renegotiate terms of an agreement on behalf of the lender), but this is not always the case since waivers also apply (for example if the agent purely collects payments).	the management to a party that has a license as a credit intermediary or a waiver, for example for credit institutions
AT	It depends on the activities performed; in case of pure outsourcing, no specific requirements necessary. Otherwise i.e. in the case of factoring, a banking license would be required. If a banking transaction is performed as listed in Art. 1 BWG, a banking license is required	Specific requirements need to be fulfilled, for instance in the case of purchase of receivables (factoring) but also other set ups might be possible (SPV) and depending on the funding and construction/transactions performed, a full banking license might be necessary
PL[174]	Authorisation required	an Alternative Investment Fund Management structure is required in order to invest in portfolios from the supervised industry
PT	According to article 5(2) of the Portuguese Securitisation Law, the Portuguese Securities Market Commission (*Comissão do Mercado de Valores Mobiliários* or CMVM) can authorise a loan servicer other than the Seller. The Law does not establish specific requirements, but the servicer is required to meet certain 'fit and proper' criteria, and adequate human and operational resources. For the servicer to grant new credit (fresh money), it must be a credit institution, since only credit institutions may grant credit professionally.	Under Portuguese banking law there is no specific legal framework regulating the transfer of bank loans. However, since lending is legally qualified as a restricted activity, only credit institutions or financial companies may acquire such loans on a professional basis without it being considered indirect lending. Nevertheless, the transfer of bank loans is not considered indirect lending if those are already non-performing loans. Therefore, the answers below rely on the assumption that the transferred loans in question are not non-performing loans, since none of these restrictions would otherwise be applicable.
RO	The entities performing debt recovery activity need to be registered with the National Authority for Consumer Protection. In case of refinancing full banking licence is required, according to the banking legal framework, when the loan servicer is not allowed to carry out lending activities in accordance with the relevant applicable legal framework. Neither the loan servicers nor the loan servicing activities are regulated by Romanian legislation related to non-bank professional creditors.	In order to legally acquire a performing loan, the buyer is required to be a creditor (is required a full banking licence in case of a credit institution or the registration as a non-bank professional creditor in the NBR registers). fit and proper criteria for non-bank professional creditors are regulated. entities need to be incorporated as joint-stock commercial companies. Regarding the NPLs for individuals, the transferee (which can be only an entity performing debt recovery activity) is required to have its head office, a branch or a representative in Romania for solving potentials disputes and for being held liable in front of public authorities. The persons responsible for managing the activity shall be of good repute, knowledge and competence requirements for staff should be required, the remuneration structure of the staff should not be solely contingent on the achievement of recovery targets, nor should it be correlated solely with the amounts recovered.
SI	There are no special requirements for providers of loan services per se.	There are no specific requirements for buyers to legally acquire a loan except in case of consumer credit – the buyer has to be authorised to provide consumer credit. A bank may also transfer a

[174] Information from industry source in public consultation

	Loan servicers	NPL purchasers
		consumer credit to a buyer established as: - the insurance company (in order to repay the creditor for overdue credit obligations of the collateral), - the special purpose vehicle for securitisation, - the special purpose vehicle for the management non-performing loans
SK	The servicing of loans is not recognised as a separate activity and it falls under the definition of providing credit and loans. The servicing of a loan is considered as a banking activity requiring a banking license	In case of transfer in the virtue of Art. 92(8) of Act No 483/2001 Coll. there are no requirements as it does not have to be a bank. For the transfer via refinancing of the loan the same requirements as for the loan originator apply. According to Art. 17 of Act 129/2010 Coll. the consumer credits can be transferred on a creditor with a full authorisation to provide consumer credits, bank, foreign bank or a branch of a foreign bank or on a third party in case of a claim of a past due consumer credit or a claim which became due before the consumer credit due date is transferred or assigned.
SE	A person who collects debts on behalf of another person, or collects debts which have been taken over for collection, normally requires a permit from the Data Inspection Board. Before permission is granted, the company must have in its employment a person with professional legal experience of debt collection. The Data Protection Authority determines whether the conditions are met. Debt collecting must be conducted in a professional and judicious manner. The Data Protection Authority ensures that these rules are adhered to. This is achieved by inspections.	A person who collects debts on behalf of another person, or collects debts which have been taken over for collection, normally requires a permit from the Data Inspection Board.
SF	No [specific] requirements. The Act on collection of the payments gives some guidelines how to collect the payment with ordinary way	No special requirements
UK	Mortgages: Permission to be a mortgage administrator will require a firm to meet “fit and proper” criteria, specific form of incorporation, location of headquarters or incorporation, ability to meet operational, specific compliance and audit requirements as well as additional conduct requirements. Consumer credit: a firm wishing to be authorised will need to meet the threshold conditions, including suitability, business model and effective supervision. There are also specific conduct of business rules in the Consumer Credit (CONC) module of our Handbook.	If a firm purchases a debt, and so becomes the creditor, it needs permission for exercising, or having the right to exercise, the lender’s rights and duties under a regulated credit agreement (Article 60B(2)). Regulated mortgages: If the buyer does not expect to enter into new regulated mortgage contracts they do not need any regulatory permissions – providing they appoint a regulated firm to administer the contracts purchased. .

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PART 2/2

COMMISSION STAFF WORKING DOCUMENT

IMPACT ASSESSMENT

The development of secondary markets for non-performing loans by removing undue impediments to loan servicing by third parties and the transfer of loans (Part 1/2)

And

Accelerated Extrajudicial Collateral Enforcement (Part 2/2)

Accompanying the document

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 final} - {SWD(2018) 76 final}

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Glossary

AECE	Accelerated Extrajudicial Collateral Enforcement
ALS	Accelerated Loan Security
AMC	Asset Management Companies
CMU	Capital Markets Union
DCFR	Draft Common Frame of Reference
EA	Euro Area
EBA	European Banking Authority
EBRD	European Bank for Reconstruction and Development
EFSIR	European Financial Stability and Integration Review
EP	European Parliament
ESRB	European Systemic Risk Board
FCD	Financial Collateral Directive
FSC	Financial Services Committee
GDP	Gross Domestic Product
IMF	International Monetary Fund
MFI	Monetary Financial Institutions
MLTS	Model Law on Secured Transactions
MS	Member States
NCA	National Competent Authority
NFC	Non-Financial Company
NPE	Non-Performing Exposure
NPL	Non-Performing Loan
OECD	Organisation for Economic Co-operation and Development
RAQ	Risk Assessment Questionnaire
SME	Small and medium-sized enterprise
SSM	Single Supervisory Mechanism
TFEU	Treaty on the Functioning of the European Union
UNCITRAL	United Nations Commission on International Trade Law

1 The need to address Non-Performing Loans in the EU

Following the financial crisis, the regulatory framework for banks has changed substantially. The European Union has taken the lead in implementing reforms agreed globally at the level of the G20 and in the Basel Committee with the objective of reducing risk in the banking sector, reinforcing financial stability and avoiding that taxpayers have to contribute financially to the costs of failing banks. In addition to these measures, the institutional arrangements for the supervision and resolution of banks in the EU have been strengthened fundamentally with the establishment of the first two pillars of the Banking Union (BU): the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM).[1] As a result of these measures, the EU banking sector is in a much better shape today than in previous years.

Nevertheless, several challenges remain to be addressed, including how to decisively address the high stocks of non-performing loans (NPLs) and other non-performing exposures (NPEs)[2]. NPLs have piled up in parts of the EU banking sector in the aftermath of the financial and sovereign crises and ensuing recessions. High levels of NPLs in parts of the banking sector have posed significant risks to financial stability and the overall economy in the EU, unlike in other major economies such as the United States or Japan which have previously taken a number of actions to reduce the level of NPLs and repair banks' balance sheets.[3]

High NPL ratios[4] can weigh on a bank's short- and longer-term performance through two main channels. First, NPLs generate less income than performing loans – thus reducing bank profitability – and may cause losses that diminish the bank's capital. In the most severe cases, these effects can put in question the viability of a bank with potential implications for financial stability. Second, NPLs tie up significant amounts of a bank's resources, both human and financial.[5] Banks saddled with high levels of NPEs have therefore only a limited capacity to provide new credit to viable businesses. Small and medium-sized enterprises (SMEs) are particularly affected by the reduced credit supply, as they rely on bank lending to a much greater extent than larger companies, thereby affecting economic growth and job creation.[6] For all these reasons, the Commission has for a long time highlighted the urgency of taking the necessary measures to address the risks related to NPLs.

While tackling NPLs is primarily the responsibility of national authorities[7], there is also a clear EU dimension of the NPLs issue. Given the high level of economic and financial integration in the EU, and especially within the euro area (EA), there are important potential spill-over effects from Member States with high levels of NPLs to the economies of other Member States and the EU at large, both in terms of economic growth and financial stability.[8] Weak growth in some Member States due to elevated NPL levels might affect economic growth elsewhere. Also, weak balance sheets of just a few banks can negatively affect investors' general perception of the value and soundness of other EU banks. This can unnecessarily raise the funding costs for the sector as a whole, which may adversely affect the cost of credit to borrowers.

Addressing high stocks of NPLs and their possible future accumulation is therefore essential for restoring the competitiveness of the banking sector, preserving financial stability and supporting lending to create jobs and

[1] The third pillar of the Banking Union, the European Deposit Insurance Scheme (EDIS), was proposed by the Commission in November 2015.

[2] NPEs include non-performing loans (NPLs), non-performing debt securities and nonperforming off-balance-sheet items. NPLs, which term is well established and commonly used in the policy discussion, represent the largest share of NPEs. Throughout this document the term NPL is meant in a broad sense equivalent to NPE, and hence the two terms are used interchangeably.

[3] See, for example, FSC (2017) "Report of the FSC Subgroup on Non-Performing Loans"; FSI (2017) "Resolution of non-performing loans – policy options"; and IMF (2015) "Global Financial Stability Report, Chapter 1: Enhancing policy traction and reducing risks".

[4] The term NPL ratio refers to the ratio of non-performing loans to total outstanding loans.

[5] A large portion of the employees' time is spent dealing with lengthy procedures required to manage NPLs. As NPLs are considered riskier than performing loans, they may require higher amounts of regulatory capital if left un-provisioned.

6 Simulations by the IMF (2015b) suggest that a reduction of European Non Performing Loans to the historical average ratio (by selling them at net book value i.e. after provisioning) could increase bank capital by EUR 54 billion. This would under some assumptions enable EUR 553 billion in new lending.

[7] As also underlined in the European Semester recommendations to relevant Member States.

[8] See ESRB (2017) and IMF (2015).

growth. This analysis is shared by a number of reports from European institutions, international organisations, and think tanks.[9]

2 Recent evolution of NPLs

The general improvement in NPL ratios over recent years continued in 2017, as did the quality of banks' loans portfolios. The latest figures confirm the downward trend of the NPL ratio, which declined to 4.6% (Q2 2017), down by roughly 1 percentage point (pp) year-on-year (see Figure 1). This reduction was mainly the result of one-off events that impacted all bank-size classes, in particular smaller banks. However, the ratio remains elevated when compared to historical norms and to other regions[10] and the total volume of NPLs across the EU is still at the level of EUR 950 billion.[11]

Figure 1 EU Non-Performing Loans ratio

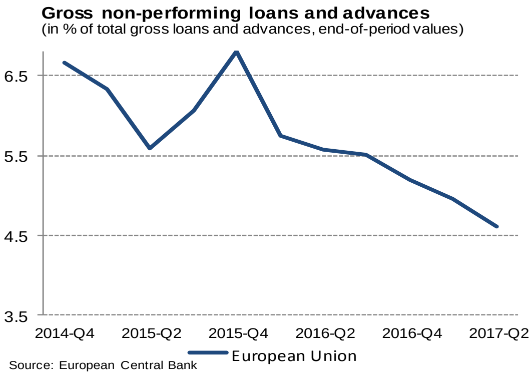
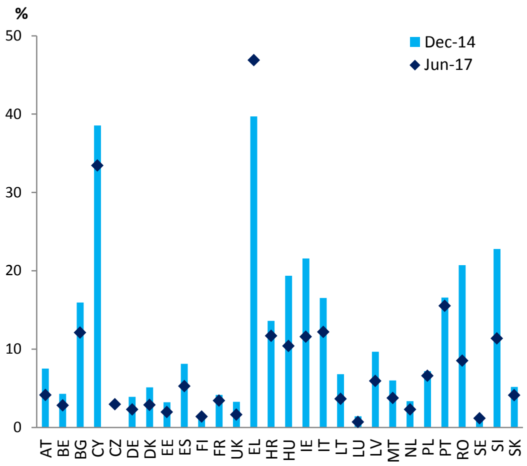


Figure 2: NPL ratio in EU Member States



Source: ECB. Note: Dec-2014 not available for CZ.

The situation differs significantly across Member States (see Figure 2). Several countries still have high NPL ratios (9 had ratios above 10% in the second quarter of 2017), while others have rather low ratios (10 Member States were below 3%).

There is evidence of some progress in reducing NPL ratios in the most affected countries, owing to a combination of policy actions and a stronger macroeconomic environment. However, significant risks to economic growth and financial stability remain and progress is still slow, especially where it is needed the most. Structural impediments continue to hamper a faster fall in NPL stocks. Provisioning is often still too slow and insufficient to allow for effectively resolving and preventing any critical accumulation of NPLs in the future. Among other elements, activity on secondary markets for NPLs is also not yet sufficient to substantially contribute to NPL reduction efforts, notwithstanding the increased interest from certain investor groups and the increasing volume of NPL-related transactions.

[9] See ECB (2016, 2017), EBA (2017), FSC (2017), ESRB (2017),.IMF (2015a, b), Vienna Initiative (2012), Baudino and Yun (2017), Bruegel (2017), Barba Navaretti et al. (2017).

[10] The NPL ratio for both the United States and Japan was around 1.5 % in December 2016.

[11] Source: ECB.

3 Towards a comprehensive package of measures to address NPLs

A comprehensive and credible strategy to address NPLs is an essential and urgent step towards restoring the viability of – and hence investor confidence in – the EU banking sector. Pursuing a comprehensive strategy and taking determined action to address NPLs is also essential for the smooth functioning of the Banking Union and the Capital Markets Union (CMU) and for a stable and integrated financial system. In this way, the resilience of the Economic and Monetary Union to adverse shocks will be enhanced by facilitating private risk-sharing across borders, while at the same time reducing the need for public risk-sharing.

Integrating national and EU-level efforts is needed to address the NPL problem, both on the existing NPL stocks and on future NPL flows. Reflecting the EU dimension and building on previous work by the Commission and other competent EU authorities, the Council adopted in July 2017 an Action Plan To Tackle Non-Performing Loans in Europe.[12] It recognises that work in this area must be based on a comprehensive approach combining a mix of complementary policy actions, since the complexity of the problem simply does not lend itself to a single *'silver bullet'* solution.

The Council Action Plan combines various measures by national governments, bank supervisors and EU institutions that improve the tools and incentives for banks to pro-actively address NPLs either by internal work-out or through disposal. In practice, this means enhancing legal frameworks relevant for both the prevention and resolution of NPLs, including the functioning of secondary markets. However, other measures such as improving the availability and quality of data on NPLs or improving the market infrastructure (eg. set-up of trading or information platforms) are equally important. If the right pre-conditions are present, tools such as Asset Management Companies are also an efficient way to allow resolution of NPLs while removing NPLs from the banking system in the short term.

The Commission has committed to delivering on the parts of the NPL Action Plan within its remit. Accordingly, the Commission announced in its October 2017 Communication on completing Banking Union a comprehensive package for tackling high NPL ratios, to be put forward by Spring 2018.[13]

This "Spring package" consists of the following measures:

- A Blueprint for how national Asset Management Companies (AMCs) can be set up in compliance with existing EU banking and State aid rules by building on best practices learned from past experiences in Member States.
- A legislative initiative to further develop secondary markets for NPLs, especially with the aim of removing undue impediments to loan servicing by third parties and to the transfer of loans to third parties.
- A legislative initiative to enhance the protection of secured creditors by allowing them more efficient methods of value recovery from secured loans through Accelerated Extrajudicial Collateral Enforcement (AECE). This refers to an expedited and efficient out-of-court enforcement mechanism which enables secured creditors (banks) in all Member States to recover value from collateral granted by companies and entrepreneurs to secure loans.[14]
- A legislative initiative amending the Capital Requirement Regulation (CRR), with regard to the introduction of minimum coverage requirements for incurred and expected losses on future NPLs arising from newly originated loans, in order to

[12] See http://www.consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans/

[13] COM(2017) 592 final, 11.10.2017, available at: http://ec.europa.eu/finance/docs/law/171011-communication-banking-union_en.pdf.

[14] This initiative will remain consistent with and complementary to the Commission proposal of November 2016 for a Directive on, inter alia, preventive restructuring frameworks and would not require harmonisation of actual insolvency provisions.

backstop potential under-provisioning of future NPLs and prevent their build-up on banks’ balance sheets.

- A way forward to foster the transparency on NPLs in Europe by improving the data availability and comparability as regards NPLs, and potentially supporting the development by market participants of NPL information platforms or credit registers.[15]

The Council Action plan initiatives under the responsibility of other EU institutions and competent authorities include, among others:

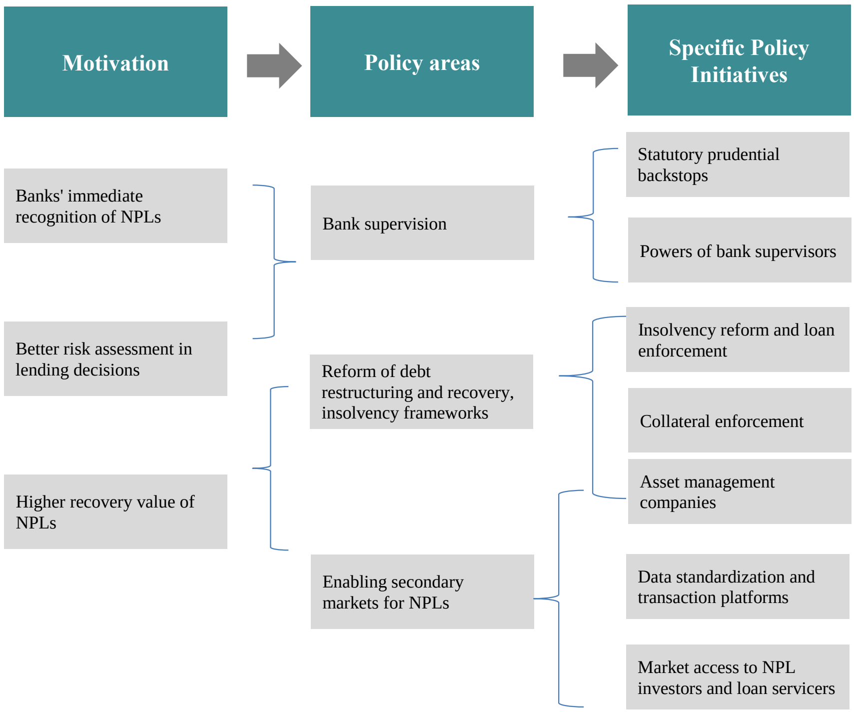
- General guidelines on NPL management applicable to all EU banks;
- Detailed guidelines on banks' loan origination, monitoring and internal governance, addressing in particular transparency and borrower affordability assessment;
- Macro-prudential approaches to prevent the emergence of system-wide NPL problems, taking into account potential pro-cyclicality and financial stability implications of NPL policy measures;
- Enhanced disclosure requirements on banks' asset quality and non-performing loans.

4 Commonalities and interdependencies of the various measures

The legislative and non-legislative initiatives of the Council Action plan are interlinked and mutually reinforcing. They should create the appropriate environment for dealing with NPLs on banks' balance sheets. Some of them have an impact on the reduction of the current stock of NPLs, and all are relevant for reducing risks of future NPL accumulation. Their impact is expected to be different across Member States and affected institutions. Some will have a stronger impact on banks' ex ante risk assessment at loan origination, some will foster swift recognition and better management of NPLs, and others will enhance the market value of such NPLs.

Figure 3 Commission's policy initiatives within the NPL Action Plan

[15] In addition, the Commission is also undertaking a benchmarking exercise of loan enforcement regimes to establish a reliable picture of the delays and value-recovery banks experience when faced with borrowers' defaults, and invites close cooperation from Member States and supervisors to develop a sound and significant benchmarking methodology. In this context, the 2016 Commission proposal for a Directive on business insolvency, restructuring and second chance lays down obligations on Member States to collect comparable data on insolvency and restructuring proceedings.

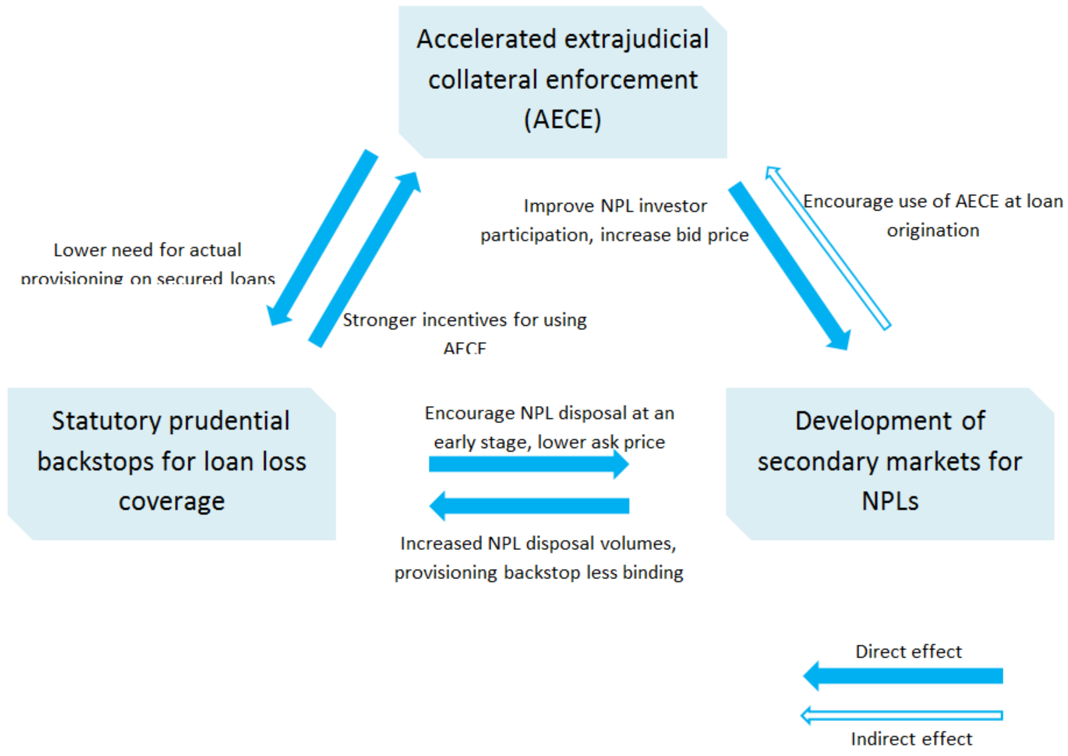


The Commission's three legislative initiatives, namely i) statutory prudential backstops for loan loss coverage; ii) the development of secondary markets for NPLs, and iii) accelerated extrajudicial collateral enforcement mechanisms, mutually reinforce each other and also interact with the other measures of the Council Action Plan. For example, the prudential backstops initiative ensures that credit losses on future NPLs are sufficiently covered, making their resolution and/or disposal easier. These effects would be complemented by better developed secondary markets for NPLs as these would make demand for NPLs more competitive and raise their market value. Furthermore, accelerated collateral enforcement as a swift mechanism for recovery of collateral value would reduce the costs for resolving NPLs. These interactions are described in greater detail in the below box.

Box on the reinforcement effects between the Commission's legislative initiatives

This box assesses the possible reinforcement effects between the three initiatives of the Spring package, namely i) statutory prudential backstops for loan loss coverage; ii) development of secondary markets for NPLs, and iii) accelerated extrajudicial collateral enforcement mechanisms. As is the usual practice, each individual impact assessment gauges the incremental effects of the proposed measure against a no policy change baseline. The underlying idea of the NPL package is, however, that the effects of each initiative will be mutually enhancing. The exact quantification of these feedback effects is a quite complex exercise as it is subject to strong modelling uncertainty. This box hence provides a qualitative description of the feedback channels and their relative strength.

Figure 4 - The reinforcement effects between the initiatives of the NPL package



Effects of Accelerated extrajudicial collateral enforcement (AECE) on other initiatives

As AECE becomes more popular and used by credit institutions, the *statutory prudential backstop* measures would be less binding. Indeed, banks would tend to restructure, recover or dispose of their NPLs earlier and at a higher rate. They would be less affected by the need to increase provisioning as time goes by, as required by the prudential backstops measures.

Given that the AECE feature would follow the NPLs following their disposal to a third party, this would help the *development of the secondary market* by increasing investor participation and thereby its liquidity (NPL demand-side effects). In particular, shorter time of resolution and increased recovery, as expected with AECE, would increase the bid prices. Moreover, the harmonization achieved by AECE would foster development of pan-European NPL investors, further improving market liquidity.

Effects of Statutory prudential backstops on other initiatives

The more costly in terms of higher provisioning it becomes for banks to keep secured corporate NPLs on their balance sheets due to the new prudential backstop rules, the higher the incentives for banks to restructure, recover or dispose of NPLs quicker and earlier, and hence the higher the *use of AECE* directly (by triggering it) or indirectly (by disposing of the NPL to a third party).

Holding NPLs on the balance sheet will become costly over time, providing an incentive for banks to dispose of NPLs on *the secondary markets* at an early stage, when the backstops require less minimum coverage. Once the minimum coverage level required by the backstops becomes more binding, the carrying book value of NPLs will be reduced. Both of these mechanisms would ensure more sellers participation on the secondary market (NPL supply-side effect), thereby reducing the ask price of NPLs.

Effects of the development of secondary markets for NPLs on other initiatives

Improved investor participation and better functioning of secondary markets would reduce the bid-ask spread and increase the volume of NPLs that are transferred to third parties. Banks would dispose of NPLs more eagerly and at an earlier stage, therefore the *provisioning backstop* would be less often binding.

With a more liquid and better functioning secondary market for NPLs where investors show appetite for NPLs with the AECE feature, there would be additional incentives for credit institutions to *use AECE* at origination of new loans. This indirect feedback effect would become active once sellers realise that it is easier to dispose of NPLs having the AECE feature to third party investors.

The effectiveness of the three aforementioned legislative measures would increase if banks are adequately capitalised in the future. Better capitalised banks will be more eager to sell NPLs in the secondary market or to realise the collateral of a non-performing loan in a timely fashion. Furthermore, statutory minimum coverage requirements would provide strong incentives for banks' management to prevent the accumulation of future NPLs through better NPL management and stronger loan origination practices. This will reinforce the expected effects of the EBA's and ECB's work on banks' loan origination, NPL management, monitoring and internal governance practices. Work on NPL information and market infrastructure would further enhance the functioning of NPLs secondary markets. Lastly, measures related to loan enforcement would complement the Commission's November 2016 proposal for a Directive on business insolvency, preventive restructuring and second chance, by increasing the chances that viable businesses survive while non-viable activities are swiftly resolved.[16]

5 The scope of the impact assessment

The measures discussed above will effectively deal with current excessive levels of NPLs and will also be effective in dealing with NPLs in the future. However, in order to reduce the risk of a future re-emergence of NPL problems, further measures need to be considered.

In order to put EU-wide brakes on the build-up of future NPLs stocks on banks' balance sheets focuses on the enforcement of secured loans the Commission is considering measures to improve the effectiveness of out-of-court enforcement of secured loans in case of borrower's default. This which could also contribute to easing the burden on courts by reducing the number of secured loans which are judicially enforced, while at the same time recognising the role of courts in safeguarding the rights of debtors. A key consideration in developing this initiative is to ensure that it shall be consistent with and complementary to the 2016 Commission proposal for a Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures[17].

The current high reliance on judicial enforcement of collateral can be costly and slow. Protection of secured creditors from borrowers' default, including through timely and clear extrajudicial collateral enforcement mechanisms, is heterogeneous across Member States. The Commission therefore explores the merits and feasibility of an Accelerated Extrajudicial Collateral Enforcement (AECE). The AECE refers to an expedited and efficient out-of-court enforcement mechanism that enables secured creditors (banks) to recover value from collateral granted by companies and entrepreneurs to secure loans. Secured creditors would not be required to wait for the result of judicial enforcement proceedings that often take a considerable amount of time and end up with low recovery rates. This is even more important in cases of cross-border lending, as extrajudicial collateral enforcement mechanisms are very

[16] COM(2016) 723 final.
[17] COM(2016) 723 final, 22.11.2016.

heterogeneous across Member States, with a wide variety in terms of approaches and efficiency. Given that these protections are currently not available to banks in all Member States, and their introduction in the entire EU could help support secured lending to firms both in terms of increasing volume and decreasing interest rates. The AECE would be a mechanism which could be used upon voluntary agreement by the parties in relation to Member States' existing security rights in order to enable banks to enforce collateral swiftly and at lower cost.

This impact assessment explores ways to enhance the ability of banks as secured creditors to enforce assets granted as collateral to secure loans by business borrowers (companies and entrepreneurs) in case business borrowers fail on their obligations in paying back the loans. Out-of-court enforcement mechanisms for collateral could usefully complement judicial procedures for collateral enforcement by ensuring an expeditious value recovering from unpaid loans in a timely and predictable manner. The current high reliance of Member States on judiciary enforcement for collateral can be costly and slow. More effective out-of-court enforcement mechanisms could incentivise banks to grant credit to companies more readily by enhancing predictability in the execution of the loan contractual terms. For the purpose of this impact assessment, the accelerated enforcement of collateral should be understood as a possible mechanism which:

> (i) is extrajudicial;
>
> (i) is of contractual nature and is agreed between a bank in its capacity of secured creditor, and a company or an entrepreneur (business loans, not consumer loans)[18];
>
> (ii) can be used for the purpose of enforcing assets granted as collateral to secure a loan, where a loan is granted by a bank (credit institution) to a company and/or entrepreneur and the collateral is represented by movable and immovable assets;
>
> (iii) grants the creditor the ability to enforce the collateral through this mechanism, but its actual use is not mandatory;
>
> (iv) the use of this mechanism is without prejudice to the right of the borrower, as well as of the creditor, to have recourse to the judicial court in relation to the use of such mechanism (i.e. to challenge the enforcement), and without prejudice to the right of the borrower to initiate preventive restructuring or insolvency procedures at any time.

A more effective and swift out-of-court mechanism for recovery of collateral value in the EU would:

> a) reduce the costs and improve the recovery from the resolution of banks' NPLs, while potentially increasing balance sheet space for future lending activities;
>
> b) mitigate the accumulation of future stocks of NPLs (and possibly help to reduce the stock of current ones[19]) by increasing the recoverable value of collateral and improving NPLs secondary market liquidity; and

[18] At credit origination, the voluntary nature of the enforcement mechanism (agreed by the counterparts) would leave the creditor discretion as to whether or not to trigger the mechanism.

c) reduce costs and increase the availability of secured lending-especially in countries where enforcement procedures are lengthy and expensive.

It would therefore contribute to ensuring the soundness of Member States' banking sectors, which is a particularly important factor for the functioning of the Banking Union, with relevance for the whole single market, given the interconecteness of the financial system. A more effective and swift out-of-court mechanism for recovery of collateral value should also contribute to achieving the CMU objectives of creating more investment, jobs and growth in the EU through a better funding of companies and entrepreneurs.

[19] The direct impact on current stocks of NPLs will depend on how much of them will be bilaterally renegotiated to benefit from this new out-of-court procedure. In addition, the potential risk mitigation effects on future build-up of NPLs can also have an indirect impact on the price of current stocks of NPLs

6 Problem definition

Background information complementing the information provided in the main body of the document can be found in Annex 7 on:

- The role of security interests and secured lending
- The recovery procedures (judicial and non-judicial) in case of debtor's default
- Related EU actions (Financial Collateral Directive and Commission proposal on preventive restructuring and second chance)
- The size of the NPL problem in the EU
- (First-order) comparison of the efficiency of the judicial system.

6.1 What is the problem?

When the debtor does not perform on its obligation to pay back the secured loan, the creditor can recover value from the collateral through an enforcement procedure. At face value, the value of the assets given as collateral is in general sufficient to cover the value of the outstanding debt obligation. However in practice **a security right has a reduced value to a secured creditor if it cannot be enforced effectively and efficiently**. High costs of enforcement of the security rights may be one of the reasons behind banks' reluctance to trigger a collateral enforcement procedure. In a high debt context, several coordination problems may also arise and lead to banks' slow resolving of secured bad loans. Bricongne et al. (2016) discuss three such problems: strategic delays (lenders wait with loss recognition and hope for an improved macroeconomic context), collateral meltdown (simultaneous sale of collateral by all lenders leads to a sharp fall in asset prices), and court congestion (judicial resources available for resolving bad debts may be insufficient in times of bad debt stress).

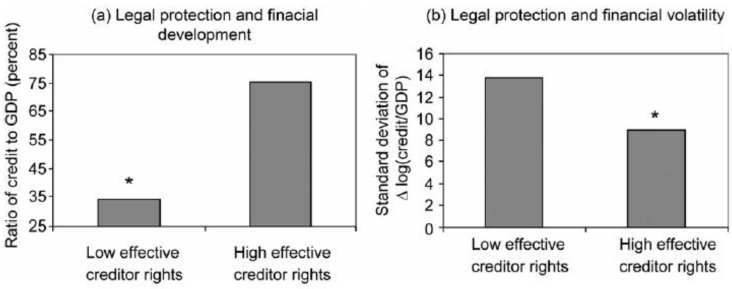
When procedures for enforcing collateral are lengthy and costly, the microeconomic benefits of the use of collateral, as reviewed in the annex 7 (section I) are impaired. Ex ante, banks tend to lend less and/or at higher lending rates, because they take into account their possible future difficulties to recover value from the encumbered asset in event of borrower default. From a debtor’s perspective, the lengthy proceedings can also increase moral hazard, as debtors might be well aware that the collateral will not be easily and quickly enforced and that they may be less incentivised to pay their loans in a timely manner. Both of these factors limit the overall funding available for business expansion and slow down trade, investment, and economic development.[20] Ex post, once banks accumulate on their books a large stock of bad loans for which recovery of value from collateral is difficult; their ability to extend credit to the rest of the economy is impaired. This may reduce the speed at which an economy can recover from a downturn and may lead to protracted periods of sluggish growth.

Existing research confirms that weak creditor protection and weak enforcement not only reduce the financial development and the provision of funding to the economy but

[20]https://www.oecd.org/investment/toolkit/policyareas/investmentpolicy/contractenforcementanddisputeresolution.htm

also make credit markets more volatile i.e. more responsive to external shocks (see Figure 5 below).[21] Moreover, Aiyar et al. (2015) show that weak debt enforcement raises the legal cost of debt restructuring and hampers banks' ability to seize loan collateral, reducing the expected recovery rate on delinquent loans (left panel of Figure 6). NPLs tend to be lower in countries where recovery periods are shorter (right panel of Figure 6).[22] The ability to enforce credit claims (in particular through collateral foreclosure) is essential to efficient debt workouts as it enables creditors to enforce their claims as a going or gone concern in a predictable, equitable, and transparent manner. Finally, empirical research shows that the enforceability of collateral matters for the structure and pricing of loans, again showing a direct impact on lending available to the economy. A comparison by Bae and Goyal (2009) of the effect of differences in legal protection across countries affect the size, maturity, and interest rate spread on loans to borrowers in 48 countries shows that banks respond to poor enforceability of contracts by reducing loan amounts, shortening loan maturities, and increasing loan spreads.[23]

Figure 5 – Legal protection and financial development/volatility



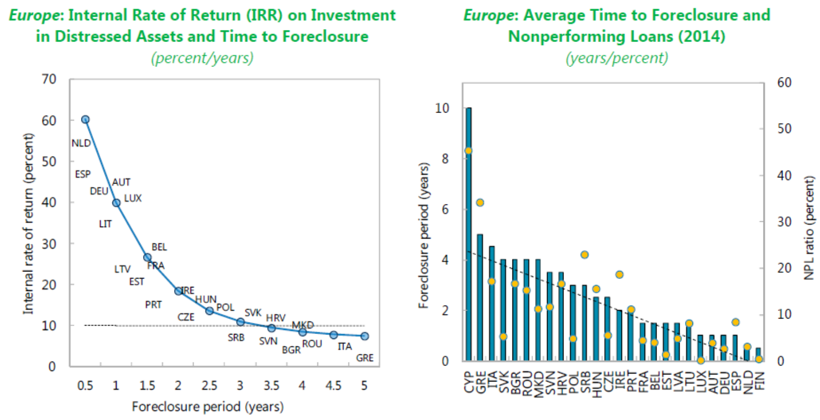
Source: Creditor Protection and Credit Response to Shocks; Note: Panel (a) shows how the development of credit markets (as measured by the ratio of credit to the private sector supplied by the financial sector to GDP) is strongly related to a measure of legal protection to creditors. Panel (b) shows that the volatility of credit—measured as the standard deviation of the annual real growth rate of the ratio of credit to GDP—is significantly smaller in countries with stronger creditor protection.

[21] Galindo, Arturo José, and Alejandro Micco. 2007. "Creditor Protection and Credit Response to Shocks." World Bank Economic Review 21 (3): 413–38.

[22] The time to foreclosure data used by the IMF comes from the World Bank Doing Business analysis which based on a survey of practitioners on a fictitious case whereby company has too many creditors to negotiate an informal out-of-court workout. The following options are available: a judicial procedure aimed at the rehabilitation or reorganization of the company to permit its continued operation; a judicial procedure aimed at the liquidation or winding-up of the company; or a judicial debt enforcement procedure (foreclosure or receivership) against the company. The period of time measured is from the company's default until the payment of some or all of the money owed to the bank on its secured debt.

[23] Kee-Hong Bae and Vidhan K. Goyal , The Journal of Finance, Volume 64, Issue 2 (04), Pages:823-860, 2009.

Figure 6 – IRR on Investment in Distressed Assets Time to Foreclosure & Average Time to Foreclosure and NPLs



Sources: ECB; World Bank Doing Business Survey (2014); RBS Credit Strategy; and IMF staff calculations

Source: A Strategy for Resolving Europe's Problem Loans – September 2015 – IMF Staff Discussion Note

Enforcement procedures in case of debtor's default are usually of judicial nature (see section 2.2.2), requiring the involvement of the court. Inefficiencies in the judicial system (see problem driver 2 below) can then slow down the formal foreclosure process, inevitably reducing the recovery value for banks in case of borrower's default and contributing to the accumulation of NPLs in banks' balance-sheet. This is particularly the case for banks operating in Member States where extra-judicial mechanisms allowing for a swift out-of-court enforcement of collateral are missing or not efficient (see problem driver 1 below).

With the current divergences in the functioning of EU's Member States' collateral enforcement frameworks - both judicial and extrajudicial - secured creditors need to assess the impacts of different legal systems on their cross-border exposures. Cross-border lending transactions require participants to research and comply with many different requirements. In a cross-border transaction involving collateral located in multiple jurisdictions, this task can be both complicated and expensive. Securing a loan with the equipment of a multinational manufacturing company, for instance, requires the creditor to determine and comply with relevant security rules in each country in which that company maintains operations.

This slows down the recovery, generates excessive costs and constitutes a barrier to cross-border lending in the Single Market. In particular, due to the current divergences in MS legal framework, uncertainty or lack of security recognition and the potential obstacles to foreclose collateral can also be an *ex ante* deterrent for banks to provide lending and to enforce their loans on a cross-border basis. When some secured debtors default and the banks are not able to recover value from these loans, they are exposed to the risk of accumulating NPLs in their balance-sheet.

6.2 What are the problem drivers?

6.2.1 Absence, inefficiency and fragmentation of out-of-court collateral enforcement mechanisms in the EU (Problem Driver 1)

Enforcement mechanisms are instruments whose purpose is to ensure that each party to a contract will stick to the contractual terms. In general, two types of enforcement mechanisms exist in Member States: judicial enforcement and extrajudicial enforcement. In the case of a secured loan, the issue is not whether the collateral can be enforced but rather under what time frame, at what cost, and how effectively it enables the creditor to recover value. To be effective, the costs of enforcement must not outweigh the gains achieved from increased contractual commitment.

At present, judicial enforcement is the most commonly used enforcement method for secured loans in EU Member States[24]. This means that once the debtor is in default, *i.e.* has not honoured its obligations of the loan, the most common way to recover value from collateral relies in a judicial proceeding. This is the case even in Member States which have established extrajudicial enforcement mechanisms. When judicial procedures are formalistic, cumbersome and cannot be resolved in a timely and cost effective manner, banks tend to reduce the amount of lending because of the uncertainty related to their ability to recover value from collateral.

Extra-judicial mechanisms to foreclose collateral are a useful alternative way to judicial proceedings. At EU level a harmonised framework on out-of-court foreclosure has so far only been established for *financial collateral*, as per the FCD (see annex 7 section III.A). **At national level, extra-judicial mechanisms to foreclose non-financial collateral are currently available only in some Member States**. Some Member States have implemented legislative reforms to provide banks with security rights which allow for a swift out-of-court enforcement of collateral, alleviating thereby the burden on the judicial system (see also driver 2 below).

Generally three types of out-of-court enforcement procedures exist in the Member States. Within a given Member State, not all three procedures are usually available. The creditors can be entitled to:

- "Appropriation" of the asset granted as collateral (the appropriation mechanism). Under this procedure the creditor acquires the full ownership of the collateral without a court order for enforcement. The creditor would then be able to keep the asset or to dispose of it (i.e. sell it) as it wishes;
- Sell the assets by means of a "public sale", meaning they can mandate a public authority[25] to organise a public auction according to general rules, and the creditor will receive the proceeds;
- Sell the asset by means of a "private sale" on behalf of the debtor and to keep the proceeds to cover the loss from the defaulted loan; in that case, special rules need to be in place to make sure the sale happens at a fair market price because the creditor would be incentivised to sell at just the price needed to cover the outstanding amount of the loan, including at below market value[26].

[24] Academic study: *Security Rights and the European Insolvency Regulation* - http:// f.wpengine.netdna-cdn.com/files/2014/07/SREIR-Roman-Legal-Systems.pdf.
[25] Except for the judicial authority which is also possible under national laws.
[26] In all cases, whether the creditor recovers value in excess of the outstanding amount of the loan, it is foreseen that the excess amount should be returned back to the borrowing company

These three existing out-of-court mechanisms can be triggered under different national terms and conditions and bring to different outcomes across Member States.

Recent work performed by the SSM[27] (and reflecting the views of National Competent Authorities (NCAs) in the area of banking supervision) shows that the legal frameworks for collateral enforcement diverge across the SSM. Over one-third of the countries (mainly in jurisdictions with high NPL levels) consider the topic to be a challenge for NPL resolution, largely due to the lack of a modern legal framework enabling timely out-of-court collateral enforcement.

Based on the input provided by the SSM which is complemented by information collected by the Commission services from Member States' ministries of Justice and publicly available legal studies, the Commission services performed a mapping of the current situation in Member States (see Annex 5 for the details and a summary table of the main features). The following assessment has been done based on the information available:

- **Only half of the Member States have in place out-of-court procedures for collateral enforcement for both security over immovable assets and non-possessory charge over movable assets;**
- **Three Member States (Denmark, Greece and Malta) do not have such extrajudicial systems for collateral under the form of movable and immovable assets;**
- **Existing national out-of-court procedures for collateral enforcement are heterogeneous in terms of the type and features of the enforcement procedures, the nature and scope of those procedures, the safeguards established to counterbalance the power given to secured creditors, etc.**

By running this legal mapping against the World Bank "doing business" data on resolving insolvency[28] the following correlations have been found (see

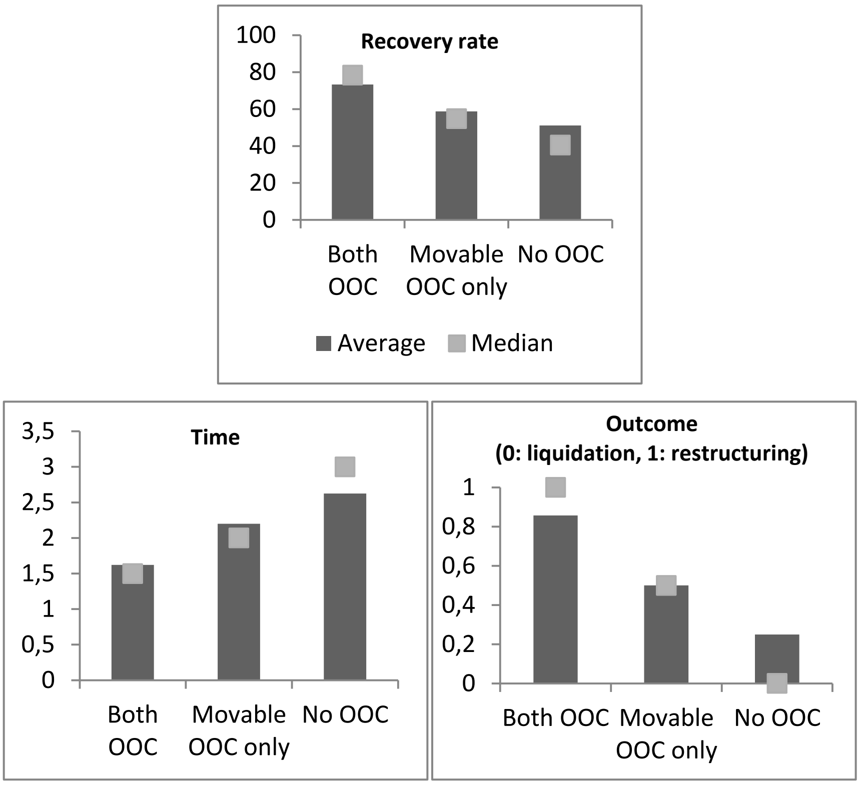
Figure 7 and also Annex 4). Although caution should be used in interpreting the data (as correlation does not mean causality and because the World Bank doing business is based on a hypothetical case and not on actual data) the following considerations could be derived:

- Member States with out-of-court collateral enforcement mechanisms on both movable and immovable assets show the highest recovery rates, the lowest time to recovery, and the best outcome in terms of company preservation (i.e. restructuring instead of liquidation);
- The opposite could be said about the Member States without out-of-court collateral enforcement mechanisms;
- Those Member States which have out-of-court collateral enforcement mechanisms only available for the enforcement of movable assets sit in between the above two categories of Member States.

[27] ECB/SSM - Stocktake of national supervisory practices and legal frameworks related to NPLs – June 2017

[28] The methodology and the description of the variables can be found here http://www.doingbusiness.org/Methodology/Resolving-Insolvency

Figure 7 – Recovery rate, Time and Outcome based on the availability of out-of-court enforcement (for immovable and movable assets) in EU Member States



Source: World Bank Doing Business, Commission services. Note: OOC is out-of-court, recovery rate is in percentage points, time in years. Time and Outcome are the underlying variables in the calculation of the recovery rate in the WB DB dataset.

In particular, extrajudicial collateral enforcement faces significant difficulties in cross-border settings. Such difficulties stem from the lack of recognition of uncertainty in case of conflict in applicable national law (*i.e.* international private law). For instance, the complexity can arise when the asset - especially if immovable - is located in a Member States different from the Member States whose applicable law governs the loan (as per Rome I Regulation)[29]. Therefore, **the complexity/divergent national rules decrease the effectiveness of cross-border enforcement and further hinder the smooth functioning of a more and more integrated EU financial market**.

6.2.2 *Inefficiencies[30] of the judicial system in some Member States (Problem Driver 2; out of scope)*

As mentioned above, enforcement procedures are usually of judicial nature. In many countries, there are lengthy, complex and costly court proceedings[31]. The sharp rising

[29] http://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A32008R0593.

[30] As explained in Annex 7 section III.B, the Commission proposal on preventive restructuring and second chance proceedings is expected to also improve the efficiency of the Member States' judicial systems hence partially addressing this problem driver

[31] Early restructuring and a second chance for entrepreneurs – Factsheet November 2016 – European Commission.

numbers of insolvencies in some Member States as a result of the financial crises, together with the lack of efficient and swift out-of-court mechanisms (to enforce the collateral in case of secured loans), have congested the judicial system, causing long delays in formal debt resolution. In the majority of EU countries, the average foreclosure period ranges from three to five years, whereas in some countries they take between 10 and 20 years (Cyprus and Greece)[32]. In Italy for example it takes 40 months for creditors to take possession of assets posted as collateral[33].

As revealed by a survey conducted by the SSM[34], national competent authorities in the area of banking supervision, in jurisdictions with high NPLs levels, consider the inefficiencies of the court systems a challenge for NPL resolution in the majority of the surveyed countries, mainly owing to the excessive length of proceedings due to the clogging-up of the courts. The IMF survey[35] conducted in 2015 on 19 countries including 9 euro area members[36] reveals that the inefficiencies of national judicial systems are viewed as either a medium or a high degree of concern for debt resolution in nearly two-thirds of surveyed countries.

According to the RAQ (Risk assessment questionnaire) performed by the EBA, banks consider lengthy and expensive judiciary processes to enforce the repossession of collaterals[37] as one of the main impediments to resolve NPLs (agreement of about 65% as of December 2016 with a significant increase from the previous year). The lack of a market for transactions in NPLs and / or collaterals is considered as the second most important impediment (agreement of about 50% in both periods). Annex 8 presents a comparison of the efficiency of the judicial system in the Member States, based on World Bank data.

6.3 Consequences

The fact that secured creditors cannot effectively and swiftly recover value from their security rights in case of a corporate borrower' default leads to:

- On the lender side: accumulation of high level of NPLs
- On the borrower side: lending to corporates is somewhat impeded and more expensive (with possible cross-border spill-over effects).

The sub-sections below provide a detailed explanation and evidence of these two main consequences.

[32] Resolving non-performing loans in Europe – ESRB – July 2017.
[33] http://www.italy24.ilsole24ore.com/art/markets/2016-05-04/padoan-192307.php?uuid=ADu9aj.
[34] ECB - Stocktake of national supervisory practices and legal frameworks related to NPLs – June 2017.
[35] A Strategy for Resolving Europe's Problem Loans – Technical Background notes - September 2015.
[36] The countries that were targeted for inclusion in the survey were those where NPLs (or NPEs) exceeded 10 percent of total loans (or total assets) at any point during 2008-2014. The country survey was completed by 19 countries, including 9 euro area members (Cyprus, Greece, Ireland, Italy, Latvia, Lithuania, Portugal, Slovenia, and Spain) and 10 non-euro area countries (Albania, Bosnia and Herzegovina (from two separate jurisdictions), Croatia, Hungary, Iceland, Romania, Macedonia, Montenegro, San Marino, and Serbia).
[37] Including in insolvency proceedings.

6.3.1 *Accumulation of high level of NPLs (Consequence 1)*

The financial crisis and ensuing recessions have left some European countries with high level of NPLs, and, in some cases, large corporate and household debt overhangs. Annex 7 section IV describes the size of the problem in the EU with recent figures.

A bank loan is considered non-performing - generally speaking[38] - when more than 90 days pass without the borrower paying the agreed instalments or interest. A performing loan will provide a bank with the interest income it needs to make a profit and extend new loans. When customers do not meet their agreed repayment arrangements for 90 days or more, the bank must set aside loan loss provisions on the assumption that the loan will not be paid back. In a nutshell, this reduces banks capacity to provide new loans hence:

- i) negatively affecting the overall provisioning of funding to the economy[39] (see section 2.3.2); and
- ii) impeding the good functioning of monetary transmission mechanism by which central banks intend to influence the aggregate demand, interest rates, and amounts of money and credit in order to affect overall economic performance.

As also documented by Council's Financial Services Committee report non-performing loans[40], the increases in NPL stocks and persistence of high NPL ratios, as a legacy issue, are generally linked to the deep economic downturn following the global financial crisis and the slow recovery thereafter. Econometric analysis has documented that **real GDP growth is the main driver of NPL ratios: a drop in economic activity remains the most important general risk as it weakens borrowers' debt service capacity, particularly for those borrowers that were overleveraged, leading to an increase in payment arrears and loan defaults and decrease in bank asset quality**. There is a strong correlation between high NPL and weak economic performances. Real GDP growth and unemployment are two traditional drivers of NPLs and conversely NPLs also have a detrimental impact on economic growth: high NPLs reduce profitability, increase funding costs and tie up bank capital, which negatively impact credit supply and ultimately growth.

In addition to economic drivers, NPL levels are significantly influenced by other factors, the impact of which is however difficult to quantify, due to the complexity of these factors as

[38] The commonly used term "non-performing loan" (NPL) is based on different definitions. The European Banking Authority (EBA) therefore issued a uniform definition of "non-performing exposure" (NPE) in order to overcome the problems deriving from the existence of different definitions: non-performing exposures are those that satisfy either or both of the following criteria: i) material exposures which are more than 90 days past-due; ii) the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due. NPE definition is – strictly speaking – currently only binding for supervisory reporting purposes. Nevertheless, institutions are strongly encouraged to use the NPE definition also in their internal risk management and public financial reporting. Furthermore, the NPE definition is used in several relevant supervisory exercises (e.g. SSM asset quality review, EBA stress test and transparency exercises).

[39] For example according to EBA's Report on Funding Plans 2017 there is a correlation between NPL ratio as of 2016 and loan growth forecast for 2017 at bank level with especially less capitalised banks being more sensitive to the NPL ratio than higher capitalised banks when considering extending new (household and non-financial corporations) lending.

[40] http://data.consilium.europa.eu/doc/document/ST-9854-2017-INIT/en/pdf

well as a lack of comparable and counterfactual data and country-specific or bank-specific features. These include, but are not limited to, banks' lending and monitoring policies, supervisory action, accounting standards, transparency of market for collateral assets, banks' capacity to deal with NPLs with the appropriate expertise, underdevelopment of distressed debt markets, tax regimes, and **the efficiency of legal and judicial systems including insolvency frameworks**.

With regards to the latter, in some Member States, the sharply rising numbers of bankruptcy or restructuring cases have also strained the judicial system, causing long delays in formal debt liquidation. As a consequence, NPLs were kept on balance sheets longer, aggravating their impact on bank profitability and long-term viability. NPLs impact bank profitability in manifold ways. NPLs imply higher provisioning needs and therefore absorb bank capital and lower operating income. Net profits are further reduced by the greater need for human resources and higher administrative expenses to monitor and manage the NPL stock. Profitability can also be reduced by higher funding costs for banks as concerns about asset quality challenges are associated with higher risk premia on bank liabilities. One way for banks to manage these balance sheet risks is through setting up adequate loan loss provisions which are liabilities set aside as an allowance for uncollected loans and loan payments covering a number of factors associated with potential loan losses including bad loans, customer defaults and renegotiated terms of a loan that incur lower than previously estimated payments.

On top of loan loss provisions, in case of secured debt, banks can cover their NPLs with collateral. Nevertheless as explained in the drivers section, while being a key tool to secure the repayment and/or recovery of a loan, **acquisition of collateral is often a lengthy and costly process eroding the net present value of the collateral concerned.** This then not only influences a bank’s ability to commence legal proceedings against borrowers or to receive assets in payment of debt but also affects collateral execution costs in loan loss provisioning estimations (i.e. requiring higher loan loss provisions hence negatively impacting the level of profits and capital ratios).

In order to deal with their stock of NPLs, banks can deploy essentially three different strategies: (i) collection of the due amount, (ii) sale to third parties investors and (iii) restructuring of the loans.

(i) As explained in the drivers section the collection approach, which includes the enforcement of collateral in case of secured loan is dependent on the efficiency of the legal system to provide the creditor with tools to enforce its loan within a reasonable time. However as argued also by the IMF[41], the long delays in collection and the low rates of recovery also affect the other two approaches to deal with NPLs.

(ii) With regards to the sale to third party investors strategy, the current low levels of trading in NPLs on secondary markets can be explained to a large extent by substantial

[41] IMF Working Paper WP/16/134 – José Garrido

information asymmetries intrinsic to this kind of markets[42]. However, there is a clear impact of the time of recovery of claims on the price of NPLs increasing the "bid/ask" spreads: the delays depreciate the value of the NPLs, and the prices buyers are ready to pay, after discounting the delays, are not attractive for the banks. The data on the size of that gap is scant but it is thought to be very large. For instance, estimates suggest that, for a fully collateralised non-performing loan, the discount required by a private investor may exceed 40% solely due to the cost, time and uncertainty of the recoveries[43]. Long time to recover loans has hence a negative impact on the price of NPLs. A recent study[44] tried to quantify what would be theoretically the increase in the price of the NPLs as an effect of the reduction in time to enforce NPLs. According to their model, the authors conclude that a reduction in the time of recovery from six years to five years would increase the price of NPLs from 12.9 percent to 16.1 percent of the gross book value of the loans (the model assumes an internal rate of return of 20 percent). A reduction to four years would raise the price to 19.8 percent, to three years would set a 24.4 percent price, to two years to 29.8 percent, and if the collection time would be reduced to one year, the estimation is that the price of NPLs would reach 36.3 percent of the nominal value of the loans.

(iii) Finally, the delay in enforcement also interferes with debt restructuring strategies. As a consequence to avoid an increase in NPLs and defaults, some banks choose to renew high-risk loans that they would otherwise not renew hence subtracting potential lending to new viable projects.

6.3.2 *Lending to corporates is impeded and more expensive including cross-border spill-over effects (Consequence 2)*[45]

As already mentioned in the section above, **high NPLs reduce bank lending to the real economy**. The figure below (Figure 8) shows how visible the contraction in bank lending has been for NFCs in Category 3 Member states (as explained in Annex 7 – section IV these are countries with currently high level of NPLs). Although it is not easy to disentangle the credit supply from the credit demand effects the reduction in the former is linked to the several (supply) factors affecting banks:

- Lower available capital. Because of their high risk weight, (especially uncollateralised) NPLs tie up substantial amounts of capital, which in turn reduce the room for expanding credit or raise the cost of doing so.
- Lower profitability. The necessity of provisioning for NPLs reduces banks' net income and the reduced returns on NPLs also reduce profits. Reduced profits in turn result in fewer loans, other things being equal.

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[42] On the demand side, banks' informational advantage over investors on the quality of loan portfolios and prospective recoveries may deter potential market activity. Moreover, barriers to entry such as licensing requirements further inhibit the market. On the supply side, banks may be insufficiently capitalised to recognise loan losses, or they may want to wait for an economic recovery before reducing their NPLs (EFSIR 2017)

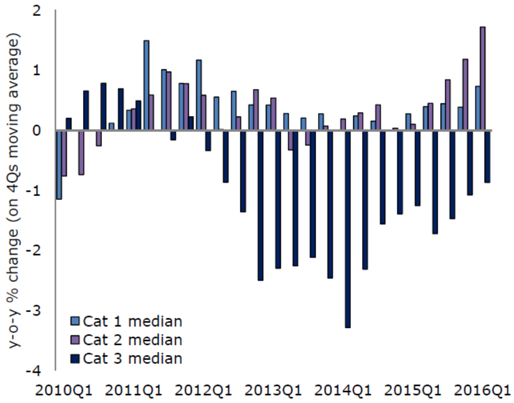
[43] Keynote speech by Vítor Constâncio, Vice-President of the ECB, at an event entitled "Tackling Europe's non-performing loans crisis: restructuring debt, reviving growth" organised by Bruegel, Brussels, 3 February 2017

[44] Ciavoliello, L. G., Ciocchetta, F., Conti, F.M., Guida, I., Rendina, A., and Santini, G., 2016, "What's the Value of NPLs?"Notes on Financial Stability and Supervision, No. 3. (Banca d'Italia).

[45] This section is mainly derived from a Commission DG ECFIN analysis "A macroeconomic perspective on non-performing loan" – 2016.

- Higher funding costs. Debt issued by banks with a high burden of distressed assets is perceived as riskier, and a premium is therefore required by bondholders. Uncertainty on the asset quality of individual banks may also limit their access to wholesale funding.
- Monitoring and servicing costs. The need to monitor distressed borrowers raises banks' operating costs.

Figure 8 – MFI lending to non-financial corporations, EU (2010Q1-2016Q1)



Source ECB, DG ECFIN calculations

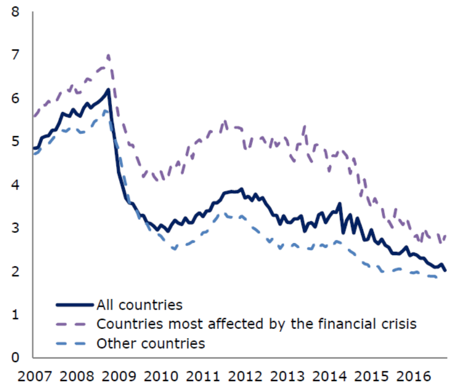
The contraction in lending has been stronger for NFCs than for households[46] possibly reflecting also the average shorter residual maturities of corporate loan books which translate into greater volatility of loan stocks and greater deleveraging opportunities compared to household mortgage lending.

Moreover it is noteworthy that this decrease in lending seems to have taken place after the spike in NPL ratios (in 2012/2013) when banks had to build up their provisioning in reaction to an increase in nonperforming exposure in their loan book. In Category 2 Member States, lending to NFCs started to pick up again (since the first quarter of 2015) in line with decreasing NPL ratios, thus highlighting remarkable differences in behaviour across categories of countries.

Problems associated with a high ratio of NPLs in the banking sector have a bearing not only on the availability of bank lending but also on the cost of credit to NFCs. Indeed, in order to compensate for the costs derived from the stock of NPLs (including the lower recovery rates from lengthy and costly enforcement procedures) banks may charge higher interest rates and tighten credit standards creating a vicious circle, whereby an increased cost of debt for the non-financial sector translates into a higher incidence of financial distress, thus propelling further increases in costs and reductions in the volume of credit[47]. As shown below (Figure 9) there is a clearly divergence of lending rates for NFCs in the EA countries affected by the financial crisis. Monetary policy transmission in the EA is then negatively affected by elevated NPL ratios in particular given the dominance of bank lending in the financing of European corporates.

[46] The lending contraction for households over the same period never exceeded 1.5%.
[47] Hou, Y. and D. Dickinson (2007), "The Non-Performing Loans: Some Bank-level Evidences. Research Conference on Safety and Efficiency of the Financial System".

Figure 9 – Cost of borrowing for NFCs, EA (Jan 2007-Oct 2016, in %)



Source ECB Note: Countries most affected by the financial crisis include Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Slovak Republic

High NPLs levels, despite being present in a subset of EU countries, are an issue for the entire EU owing to a range of important cross-border spill-overs[48].While there are strong benefits from financial integration in the EU in terms of risk diversification, in such a deeply integrated area, economic and financial difficulties in one Member State can also have a bearing on other Member States even outside of an acute crisis situation. The spill-over effects can arise both within the banking sector and between the banking and non-banking sectors. Banking spill-overs relate to banks' cross-border lending activities and cross-border ownership links (see below). Furthermore, indirect channels relate to the overall deterioration of the macroeconomic environment in high-NPL countries, which affects other countries through lower import demand (trade channel) and a loss of value of equity and debt claims on residents of the affected countries (financial channel).

With regards to cross-border lending spill-over effects can take place either via *domestic* bank lending or the lending of *foreign* banks. Spill-overs via *domestic* banks occur when the increase in the NPL ratio in a foreign banking sector is affecting the loans handed out by domestic banks operating in that foreign market and these banks are subject to the same structural deficiencies that prevent a timely resolution of NPLs in the foreign country. In this case, the NPL exposure in the foreign market can tie up risk capital, which is not available for lending activities in the banks' home market. Spill-overs via *foreign* banks, on the contrary, occur when banks in one Member State feel compelled to cut back their cross-border lending activities, due to the constraints they face because of high NPLs in their domestic loan book, and thereby reduce credit supply in other Member States. Unless the impact on lending in the home countries of the affected banks is compensated by an increase in lending from competitors, both channels lead to a situation in which problems associated with high NPLs in one Member States can have an impact on credit supply in other Member States.

While it is impossible to verify and quantify empirically the aforementioned channels of cross-border spill-overs, it is nevertheless possible to assess at least which Member States could be more vulnerable to such spill-over effects due to a relative larger cross-border exposure of bank assets. By looking at the Bank for International Settlements (BIS) data on cross-border net risk transfer[49]:

[48] Resolving non-performing loans in Europe – July 2017 – ESRB.
[49] See table I.2 and I.3 of Commission DG ECFIN analysis "A macroeconomic perspective on non-performing loan" – 2016.

- With regards to *domestic* channel and taking Category 3 Member States one finds that for example Romanian banks seem to exhibit an elevated exposure to Greece (5.8% of Romanian GDP) or UK banks to Ireland (32.4% of UK GDP) and German banks to Italy (9.3% of German GDP)
- With regards to *foreign* channel, the data shows that for example Croatia, Austria and Hungary appear to be particularly exposed to a change in lending policy by Italian banks or Croatia, Czech Republic and Slovakia are linked to lending policy in Austria or Latvia, Lithuania, Estonia, Denmark and Finland could become considerably affected if Swedish banks were to cut back their cross-border activities

6.4 **How will the problem evolve?**

Without policy intervention, the current divergence between Member States' banking systems' ability to manage and resolve NPLs, and the subsequent effect on access to finance, will not be addressed and might even widen.

As a result, only banks operating in Member States where efficient collateral enforcement mechanisms exist will have appropriate tools to mitigate risks of future accumulation of NPLs (and possibly also manage the current stockpile of NPLs[50]). Member States where those mechanisms do not exist or are not properly functioning will run the risk of seeing lending to the economy being curtailed or made more expensive in future episodes of adverse economic conditions, as shown by the recent financial crisis in Member States with high levels of NPLs. Moreover, banks operating cross-border will continue to face fragmented collateral enforcement frameworks and will need to assess the impacts of different legal systems causing unnecessary costs and constituting a barrier to cross-border lending in the Single Market.

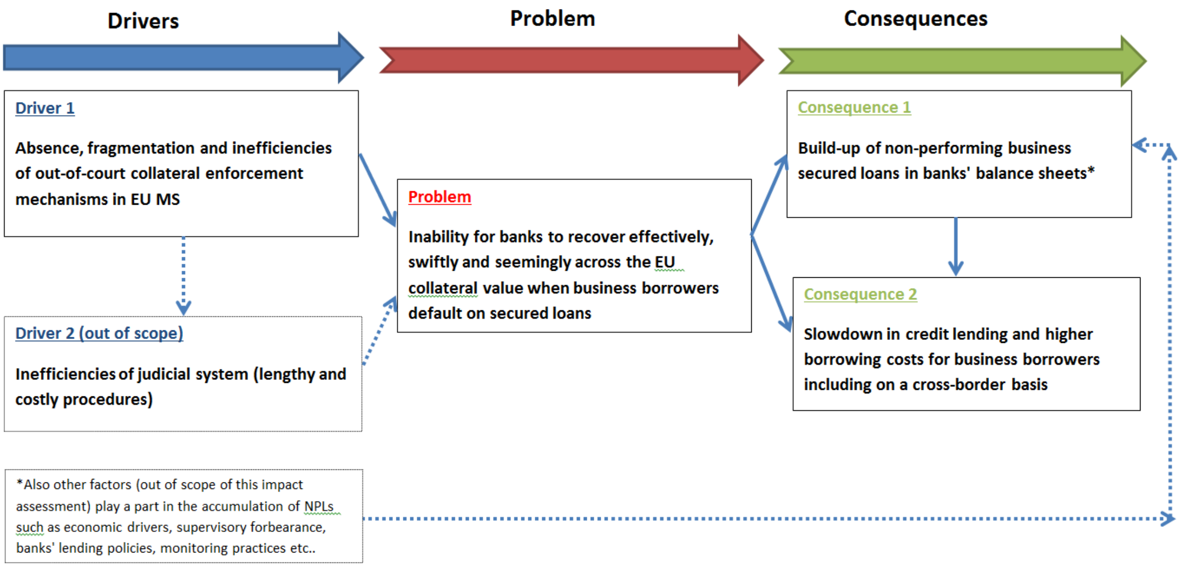
From a debtor's perspective, with the absence of out-of-court enforcement mechanisms and given the lengthy formal proceedings, the issue of moral hazard will persist. As debtors might be well aware that the collateral will not be easily and quickly enforced, they could be less incentivised to comply with their loan obligations or try to resolve their financial distress with the creditors in a timely manner[51].

Finally, a deeply integrated area like the EU (and even more so within the euro area) could see important cross-border spill-overs of future NPL problems in some Member State on other Member States.

[50] In case of renegotiation of some of the loans currently non-performing.

[51] At the same time, even if the borrower is willing to pay, its actual ability to do so depends also on external factors.

Problem tree



7 Why should the EU act?

7.1 Legal basis

Article 114 of the Treaty on the Functioning of the European Union (TFEU) confers the European Parliament and the Council the competence to adopt measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market. **Article 114 TFEU allows the EU to take measures not only to eliminate current obstacles to the establishment and functioning of the internal market, but also to address barriers that dissuade economic operators from taking full advantage of the benefits of that market (in particular investing in other Member States).**

7.2 Subsidiarity - Necessity of EU action

The previous section has shown that banks which grant secured loans to companies and entrepreneurs do not benefit in all Member States from expedited and effective procedures to enforce such loans out-of-court in case of corporate borrower's default. There is no minimum set of tools available across Member States for out-of-court collateral enforcement. Should such tools be available, the risk of banks accumulating NPLs would decrease.

In order to recover value from collateral posed by a borrower in a different Member State, the lender has to follow rules which are different from the rules of the lender's home Member State, and the efficiency of which is unknown to the lender. This creates costs with legal advice and can mean longer duration of recovery procedures, and lower recovery rates. The prospect of recovering less, or at worst, nothing, from a secured loan in case of debtor default can deter lenders from lending cross-border in the first place, or it can increase the price of lending for companies. This in turn constitutes a deterrent for borrowers for turning to lenders in different Member States. This obstructs the free movement of capital and has a direct effect on the functioning of the single market. There is untapped CMU potential in terms of making funding available to companies, SMEs in particular, which are highly reliant on bank lending.

Similarly, investors considering to buy portfolios of non-performing loans will take into consideration potential legal uncertainties in value recovery from the collateral attached to these loans, and if value recovery cross-border is more difficult or comes with legal uncertainties, this will negatively impact the price, and by consequence, the chance of banks to sell portfolios also to investors from a different Member State as close as possible to the price determined by banks' provision for those loans[52].

On that basis, the European Union has a right to act to improve the conditions for creditors (both banks and investors) and companies/entrepreneurs as borrowers. Establishing a framework on efficient out-of-court collateral enforcement procedures would ensure that secured creditors in all Member States benefit from an additional tool to recover value from a secured loan in case a corporate borrower does not pay on the loan.

7.3 Subsidiarity - Added value of EU action

An EU action would:

i. *Reduce spill-over effects in the whole EU due to NPLs accumulation in parts of the EU (i.e. when NPL problems in one Member State affect negatively the lending and the economy in other Member State) and increase banking sector stability* → As explained in section 2.3.2, the high interconnectedness within the EU (and especially Eurozone) financial system creates a significant danger of spill-overs entailing systemic risks which are better addressed at EU level. This is particularly relevant for the Banking Union, but also to the non-euro area Member States, given that banks operate in multiple jurisdictions. Increasing the stability of the banking sector with the development of a common extra tool for dealing with the accumulation of NPL could also contribute to some extent to addressing the risk of a revival of the 'diabolic loop' between banks and sovereign risk (whereby the concerns about banks' NPL levels and hence their strength affect the cost of governments' borrowing and vice-versa) that was at the heart of the recent European financial crisis;

ii. *Help the scaling-up at EU level of secondary market for NPLs (which is needed when the strategy adopted by banks is to sell the NPLs portfolio to specialised investors) through economies of scale* → Ensuring that efficient out-of-court enforcement mechanisms are available in all Member States, as explained in section 3.2.1, would reduce the bid-ask spreads in a given Member States. Moreover, a common set of features of such mechanisms across the EU would facilitate price discovery,

[52] If a bank has provisioned 30% of a non performing loan, then it disposes the loan at a value lower than 70%, this will result in a further loss for the bank

transactions and greater liquidity in loans markets[53] by pan-European investors which will be able to operate under similar conditions across the EU through economies of scale.

iii. *Create incentives for more cross-border lending by reducing uncertainty about the outcomes of enforcement proceeding (e.g. recovery rate and time) in cross-border transactions.*

The objectives pursued by these measures as discussed above can be better achieved at EU level rather than by different national initiatives. The necessity to act is even stronger in the Eurozone. As shown in section 2.3.1, lending availability and cost of credit for corporates is more tightly related to NPLs level in a given country.

The proposal also provides for proportionality as the tool will be tailored to achieve the objective of ensuring the proper functioning of the single market. Given the inherent links between collateral enforcement and Member States' civil, property, commercial, pre-insolvency, insolvency and public laws, the envisaged rules on extrajudicial collateral enforcement would need to be able to be implemented in a way that is consistent with those Member States' laws. All policy options will therefore be assessed with regards to their compliance to the principle of proportionality.

8 Objectives: What is to be achieved?

In light of the concerns outlined in the previous chapters, two general objectives will be pursued, which in turn can be articulated into one common specific objective:

- **Reduce future levels of secured NPLs in banks' balance sheets (general objective 1)** – elevated levels of non-performing loans affect financial stability as they weigh on the profitability and viability of the affected institutions and have an impact, via reduced bank lending, on economic growth. As a result, NPLs have a negative impact on both the functioning of the Banking Union and on the creation of a Capital Markets Union. The reduction of future levels of secured NPLs in banks' balance sheet (to which this initiative and others in the "NPL package" would contribute) is then paramount and is then the first general policy objective of this initiative.

- **Facilitate more lending to corporates and at lower cost, including on a cross-border basis (general objective 2)** – While general objective 1 is linked to the stability of the banking sector and better functioning of the lending activities, general objective 2 focuses instead on the other contractual party of any lending transaction i.e. borrowers. The two objectives (like the two mirroring consequences) are obviously connected as risk reduction for the banks in turn create incentives for banks to lend more (i.e. hence increasing the supply of financing available) and at better pricing conditions (including lower borrowing costs) both domestically and on a cross-border basis.

[53] As explained by "Analysis of developments in EU capital flows in the global context – Bruegel – September 2017" there are no formal restrictions in the legal and regulatory frameworks that would impede the entry of NPL investors, and their acquisition of assets but investors are discouraged to enter certain markets due to the range of obstacles in loan enforcement and liquidation like the lengthy recovery procedures, the uncertainty over their evolution and costs of these procedures.

- **Enable secured creditors to effectively and swiftly recover collateral value in a standardized way across the EU when business borrowers default on secured loans (specific objective) –** The specific objective, common to the two general objectives, is to equip banks operating in any of the Member States of EU with the possibility of recovering value in a default situation through effective and speedy out-of-court collateral enforcement mechanism governed by harmonized rules and principles.

Table 1 – Intervention logic diagram

Problem and consequences	**General and specific objectives**
Consequence 1 - Build-up of non-performing business secured loans in banks' balance sheets	General objective 1 - Reduce future levels of secured NPLs in banks' balance sheet
Consequence 2 - Slowdown in credit lending and higher borrowing costs for business borrowers including on a cross-border basis	General objective 2 - Facilitate more lending to corporates and at lower costs, including on a cross-border basis
Problem - Inability for banks to recover effectively, swiftly and seemingly across the EU collateral value when business borrowers default on secured loans	Specific objective - Enable secured creditors to effectively and swiftly recover collateral value in a standardized way across the EU when business borrowers default on secured loans

9 What are the available policy options?

9.1 What is the baseline from which options are assessed?

The expected evolution of the problem and of its consequences is discussed in section 6.4. Under the baseline scenario, no material revision of Member States' existing collateral enforcement procedures is expected.

To quantify the aggregate economic outcomes in the baseline case, the Commission services prepared a stylised scenario for future NPL levels (as the main effect of this initiative would be on future stocks) that could be reached in a future adverse economic episode in each EU Member State (see annex 4 for details about the methodology). The scenario uses country-specific benchmark NPL levels from historical data and applies a number of EU-level average parameters (e.g., share of corporate in total NPLs, share of SMEs in corporate NPLs, etc.) to end up with estimated levels of secured corporate NPLs for each Member State. The scenario should be seen as an illustration of possible future NPL levels following a severe economic shock, rather than as the forecast of NPLs in the next economic downturn.

In the stylised scenario, the **level of corporate NPL that are secured by collateral** would reach **EUR 463 bn**, of which about EUR 221 bn would be associated with SMEs. The recovered value from these NPLs under the baseline and the three policy options is estimated by applying on this stock the modelled recovery rates (see also annex 4). In the baseline it is assumed that recovery rates would stay at their current level (unweighted EU average of 67.7%, EU median of 71.7%), which would lead to the **recovery of EUR 346 bn for secured creditors**. The access to finance for EU businesses, in particular for SMEs, and the associated costs would remain heterogeneous across Member States, with slow convergence as the financial fragmentation recedes.

9.2 Description of the policy options

A total number of five policy options have been explored of which three are retained for further analysis and comparison and two are discarded at this stage. The former are described in detail in this section whereas the latter in the following section.

9.2.1 Scoping the policy options

The scope of the three retained policy options for extrajudicial enforcement procedure will be **limited to loans originated by credit institutions which are granted to companies or entrepreneurs (*i.e.* business to business relationship)**. At origination, the out-of-court enforcement procedure should therefore be restricted to only secured business loans, meaning loans between a credit institution, as creditor, and a business borrower (*i.e.* a company or a sole entrepreneur)[54], as debtor. Given the very strong social impact that an out-of-court enforcement procedure would have on consumers, such as potentially depriving a natural person of his or her main residence, or of assets which have more intrinsic value for the debtor as they are valued on the market, or are needed for daily subsistence such as furniture, **natural persons as consumers would be excluded** from its scope. The public consultation showed overall support[55] for this approach given the need for special protection for the weakest party.

On the creditor's side, because of the financial stability motivation of the work on out-of-court collateral enforcement whose primary goal is to avoid the problems of accumulation of NPLs on banks' balance sheets, **it is envisaged to only include banks (credit institutions as defined in EU law) and loans originated by them in the scope** of this initiative. Moreover, there is a need to ensure that the scope of this initiative is aligned with that of the broader legislative package which this initiative forms part of, i.e. the package aimed at addressing the NPL issue, as announced in the 2017 Commission Communication on Banking Union. Therefore, given that the EU dimension to reducing current NPLs as well as preventing future build-up of NPLs is aimed at addressing a banking problem, the envisaged scope of the initiative is to encompass loans originated by banks. Tackling the NPL issue for banks would improve the stability of the banking sector and would enable banks to make more credit available to companies, SMEs in particular. Banks would be able to better play their role in financing the economy. Moreover, it is established case-law that the principle of equality before the law, set out in Article 20 of the Charter of Fundamental Rights of the European Union, is a general principle of EU law which requires that comparable situations should not be treated differently unless such different treatment is objectively justified. A difference in

[54] At credit origination, inclusion of the enforcement mechanism would require agreement by the counterparties, i.e. be voluntary. At a later stage, one the requirements for triggering the mechanism are met, the creditor would still have discretion as to whether or not trigger the mechanism.

[55] This included the banking sector, investors and loan servicing companies, government and public authorities and consumer associations, NGOs and private individuals.

treatment is justified if it is based on an objective and reasonable criterion, that is, if the difference relates to a legally permitted aim pursued by the legislation in question, and it is proportionate to the aim pursued by the treatment[56] (cf. ECJ case-law). In the case of out-of-court enforcement, the focus on banks as secured creditors and loan originated by banks would be justified by the need to ensure that these entities do not accumulate high amounts of NPLs so that they remain capable of making credit available to companies and the real economy at large.

As regards the types of assets which corporate borrowers give as collateral, **the scope of the policy options would include movable and immovable tangible/concrete/material assets** (e.g. right *in rem*)[57] owned by the debtor or an affiliate or subsidiary. As regards the types of security rights which could be used, as explained further down, options 1 and 2 envisage using existing security rights in the Member States (i.e. pledge, mortgage, non-possessory pledge, floating charge, etc.), while option 3 envisages the establishment of new security right which would be added to the existing national catalogue of security rights. However for all the three options, **this instrument could not be invoked against certain categories of real estate properties, such as the main residence of the debtor, even where such asset guarantees a business debt.**

9.2.2 Option 1 - Non-regulatory action based on existing international harmonisation initiatives of extrajudicial collateral enforcement procedures

Under this policy option, the Commission would recommend Member States to put in place extrajudicial enforcement procedures to recover value from secured loans in case such procedures do not exist or to enhance the effectiveness of existing ones, in particular where they are not used in practice because they are inefficient. Such set of recommendations would be inspired by Member States' out-of-court collateral enforcement procedures which work well (*e.g.* because they optimise the value recovery through a speedy procedure) and by a number of international initiatives in the area of secured transactions, which include recommendations on enforcement of security rights and collateral.

As a matter of fact, the field of secured transactions has been in the past two decades at the centre of a number of international harmonization initiatives ranging from instruments intended to become legally binding to broader soft law initiatives such as:

[56] ECJ judgement of 17 October 2013, Schaible, C-101/12, EU:C:2013:661, paragraphs 76 and 77; ECJ preliminary ruling in case C-156/15, 'Private Equity Insurance Group' SIA v 'Swedbank' AS, 10 November 2016.

[57] The policy initiatives would be considered as part of a category known in some Member States of Roman Law tradition as "rights *in rem*". Right *in rem,* meaning that the asset given as guarantee is only a "concrete", "material" asset (*res*) and cannot be, for instance, a financial instrument, or other form of "personal" guarantee/warranty that involves the obligation of a third-party guarantor to pay the creditor in case of the borrower's default. Likewise, ACE will not be available for collateral over Intellectual Property and other intangible assets. The ACE would also not apply to financial collateral as regulated by the Financial Collateral Directive http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32002L0047.

(i) The 2010 Legislative Guide on Secured Transactions by the UN Commission on International Trade Law [58] and the more recent 2016 UNCITRAL Model Law on Secured Transactions[59] discussing policy issues and containing recommendations including some useful suggestions on out-of-court enforcement of security rights[60] with the aim of paving the way to domestic law reform .

(ii) Principles, definitions and model rules of European Private law Draft Common Frame of Reference (DCFR) prepared by the Study Group on a European Civil Code and the Research Group on EC Private Law (Acquis Group)[61][62]. It contains a section on "Extra-judicial enforcement"[63].

(iii) The European Bank for Reconstruction and Development (EBRD) *Model Law on Secured Transactions* (MLST)[64] aims at facilitating the transition to capital market economies and the introduction of efficient systems of security rights in Central and Eastern European Countries[65]. It provides useful definitions and provision to structure the out-of-court proceeding (e.g. as per the role of the judicial court).

The recommendation would focus on five areas:

1) Nature – This policy option would recommend Member States to ensure that an out-of-court procedure for the enforcement of collateral is available to banks in all Member States. Such mechanism would be recommended to be used upon voluntary agreement by the parties in relation to existing security rights in the Member States, in order to enable the creditor to enforce collateral swiftly and at lower cost. Moreover, even if the use of the AECE is voluntarily agreed by the contractual parties, it would be recommended not to be mandatory for the bank to use it where the borrower is in default. It will be up to the bank to assess whether or not it wishes to use this instrument.

2) Procedural features – it will be recommended that:

- The secured creditor may recover value from the encumbered assets by an out-of-court proceeding, provided that (i) the debtor has consented ex ante to extrajudicial enforcement in the security agreement, (ii) the secured creditor has given the debtor and any person in possession of the encumbered asset notice of default and of its intention to seek to enforce their right out-of-court[66];

[58] UNCITRAL - art. 131-177; https://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670_Ebook-Guide_09-04-10English.pdf, Chapter VIII, p. 310.
[59] http://www.uncitral.org/pdf/english/texts/security/ML_ST_E_ebook.pdf
[60] Chapter VIII, p. 310.
[61] Based in part on a revised version of the Principles of European Contract Law and published in 2009
[62] http://ec.europa.eu/justice/contract/files/european-private-law_en.pdf.
[63] http://ec.europa.eu/justice/contract/files/european-private-law_en.pdf, p. 4715.
[64] Published in 2004 and then in 2010
[65] EBRD *Model Law on Secured Transactions* (MLST) - http://www.ebrd.com/news/publications/guides/model-law-on-secured-transactions.html. "the Model is not intended as detailed legislation for direct incorporation into local legal systems. It is, however, intended to form the basis for national legislation". Other useful example could be (iv) Organisation of American States (OAS) Model inter-American Law on secured transactions published in 2002.
[66] Based on UNCITRAL Guide (art. 131-177)

- Obligations of secured creditors to act in good faith and follow commercially reasonable standards when enforcing their rights[67];
- Enforcement is to be undertaken by the secured creditor in a commercially reasonable way and as far as possible in cooperation with the security provider and, where applicable, any third person involved[68];
- The rights of secured creditors to enforce out-of-court should be subject to judicial or other official control, or review of the enforcement process (e.g. debtors should be entitled to request courts to confirm, reject, modify or otherwise control the exercise of a creditor's enforcement rights)[69];

3) Publicity requirements – Transparency is necessary to make third parties aware that an asset is charged by a security right, in particular but not only in the case of real estate. When the use of an out-of-court procedure is foreseen by agreement between a bank and a corporate borrower, third parties should be informed about the right of the creditor to enforce the loan by means of an out-of-court enforcement. That is why it is important to make public the bank's ability to use it, for example by registration in the relevant national public registers or equivalent forms of publicity. Under this option, one of the recommendations to Member States would be that the ability of a secured creditor to enforce collateral through an out-of-court enforcement procedure would be subject to registration in the relevant national public registers or equivalent forms of publicity. Member States would not have to put in place a specific procedure for this purpose, but they would be recommended that the out-of-court enforcement procedure follow the specific publicity requirements which apply in a Member State, depending on the type of security right in relation to which such an enforcement procedure could be used.

4) Transferability – the recommendation would invite Member States to ensure that the right to extrajudicial collateral enforcement is transferable with the security right, in order to foster the development of secondary markets for NPLs. In particular, where a secured loan equipped with an out-of-court enforcement procedure is sold by the bank to a third party, that third party (which may or may not be a credit institution) would be able to enforce collateral out-of-court in case of borrower's default (under the same conditions as the originating bank).

5) Insolvency and restructuring - The Commission would recommend that any out-of-court enforcement procedures remain fully consistent with and complementary to the Commission proposal on preventive restructuring and second chance.

Legal instrument – based on the above provisions, the Commission would set up general high-level principles and/or provisions through a **Recommendation** addressed to Member States. Such recommendation would specify common criteria of out-of-court enforcement proceedings (e.g. better ways to safeguard both parties' interests to ensure balance and fairness in the collateral foreclosure). The EU recommendation, a non-binding legislative instrument, would leave Member States the freedom whether to implement it and how to

[67] Based on UNCITRAL Guide (art. 131-177)
[68] Based on DCFR (Book IX - 7:103)
[69] Based on UNCITRAL (art. 131-177)

frame the extrajudicial enforcement mechanism by means of specific contractual or statutory solutions and procedures in compliance with their legal system.

9.2.3 Option 2 - Minimum harmonisation of extrajudicial collateral enforcement procedures

This option would require all Member States to provide for an extrajudicial collateral enforcement procedure for secured loans, which would be based on a set of common principles. Member States that currently lack or have different forms of extrajudicial collateral enforcement procedures would have to introduce such mechanism in their national legal framework or align the system in place with the *minimum* standards of harmonisation, as set up by the EU common principles.

Member States would provide creditors with an extrajudicial procedure to enforce collateral in case of debtors' default. This out-of-court mechanism would be "attached" to security rights already existing in Member States (such as mortgages and pledges) and would serve as a standard way to recover value from collateral. This option would therefore establish a number of minimum criteria at EU level for the out-of-court collateral enforcement, in order to ensure better levels efficiency, consistency and predictability in all Member States. This means in practical terms that when a loan is secured by collateral and the debtor defaults on its obligations set up in the loan agreement[70], such harmonised enforcement mechanism would allow creditors to recover value from collateral without the prior full involvement of a court, and in a standard way and timing across EU. The purpose of the initiative is to make sure creditors can use an alternative to the judicial enforcement (if absent in national legislation), and/or to improve the current out-of-court procedure (where existing) in a consistent manner across Member States. Whilst the general rules would be established at EU level to ensure coherence and consistent application, the detailed implementation of the rules would be established in national law.

A possible EU framework establishing a common set of provisions on such out-of-court procedures is called for the purpose of this impact assessment Accelerated Extrajudicial Collateral Enforcement (AECE). The EU framework would focus on five areas:

1) Nature – This policy option would introduce an obligation for Member States to ensure that an out-of-court procedure for the enforcement of collateral is available to banks in all Member States. The AECE would not establish a new security right (as per option 3 below), but rather a mechanism which could be used upon voluntary agreement by the parties in relation to existing security rights in the Member States, in order to enable banks to enforce collateral swiftly and at lower cost. The use of AECE would not be mandatory for the parties to a loan agreement, i.e. bank and a company or entrepreneur. If the parties agree to give the creditor the possibility to use AECE in case of corporate borrower's default, unless

[70] In the West's Law&Commercial Dictionary a loan is defined as a "delivery by one party to and receipt by another party of sum of money upon agreement, express or implied, to repay it with or without interest". Loan should be understood as including the various types of credit which banks grant corporates, such as credit revolving (etc.).

restructuring is triggered, then the national rules which implement the EU framework would apply, together with any other relevant national private and public laws.

2) Procedural features – The conditions which allow the bank to trigger the AECE would be defined as the borrower's default in repaying the loan. Moreover, the proposal would require Member States to make extrajudicial enforcement through private sale available to secured creditors. The availability of other enforcement methods, in particular public sale or appropriation, would be optional. The core features of the AECE would therefore be (i) out-of-court enforcement; (ii) procedural standards.

> (i) out-of-court enforcement: in case of private sale, the bank will be charged to sell the assets on behalf of the debtor with the purpose to recover the maximum value from the sale. For the other enforcement options, public sale will be regulated mainly by national rules, while appropriation will be built along the lines specifically discussed under option 3.
>
> (ii) procedural standards: any sale methods as envisaged by the AECE would have to follow a set of common high-level principles of fairness, transparency and efficiency, while the specific details of the procedure would be left to Member States.

The debtor should be able to contest and raise objections to the use of the AECE and the value obtained following its use. This translates into the debtor's right to challenge the AECE before a judicial court. Member States should be able to decide on the suspensive effects of such appeals. Finding the right balance between the power of the court and such extrajudicial enforcement should be left to Member States.

Regardless of the type of enforcement procedure which is used (private or public sale, appropriation), the creditor should have the obligation to pay back to the debtor the difference between the value of the asset (as per amount obtained from the sale or the estimated value in case of appropriation) and the amount owed as at the time of execution of the AECE (in case the latter is higher than the former). If this difference is negative, the possibility of *datio in solutum* / debtor's discharge (i.e. debtor not liable for the shortage) should be addressed at national level, together with any other solution consistent with Member States legal framework.

Given that this option does not foresee the introduction of a new security right, the AECE would not change the existing hierarchy of security rights in enforcement proceedings and would not affect Member States' rules that might privilege some special categories of creditors (e.g. workers, taxpayers etc) in insolvency proceedings.

3) Publicity requirements – Transparency is necessary to make third parties aware that an asset is charged by a security right. When the use of an AECE is foreseen by agreement between a bank and a corporate borrower, third parties should be informed about the right of creditor/bank to enforce the loan by means of an out-of-court enforcement. That is why it is important that the bank's ability to use AECE be made public, for example by registration in the relevant national public registers or equivalent forms of publicity. To minimise any impact on national registration rules for security rights, this option would set as a rule that the AECE would the subject to the same publicity requirements as those established under each Member State legal framework for the security right which is equipped with AECE. That is because AECE would not be a new security right which might require new, specific publicity, but a mechanism which follows existing security rights. This means that Member States would not have to put in place additional transparency requirements for the publication of AECE, other than those applicable, if any, for the publication of the security right which is equipped with AECE.

4) Transferability – this option will introduce an obligation to ensure that the right to extrajudicial collateral enforcement is transferable with the security right, in order to foster the development of secondary markets for NPLs. In particular, where a secured loan equipped with AECE is sold by the bank to a third party, that third party (which may or may not be a credit institution) would be able to use AECE in case of borrower's default (under the same conditions as the originating bank).

5) Restructuring and insolvency – The AECE will remain consistent with and complementary to the Commission proposal for a Directive on preventive restructuring and second chance COM (2016) 723[71]. This should be ensured in particular through the principle that once a restructuring proceeding is triggered or a "stay" is granted (under art. 6 of Commission proposal)[72], the AECE enforcement is suspended. A 'stay of individual enforcement actions' means a temporary suspension of the right to enforce a claim by a creditor against a debtor, ordered by a judicial or administrative authority[73].
This option will not affect the national rules and principles of pre-insolvency and insolvency proceedings, which in case of conflict would prevail to the extent granted by national law. Therefore, an AECE would not prevent those provisions from having their desired effects, thereby maintaining the balance of debtors and creditors' interests and the order of priority of different creditors. The AECE would remain consistent also with the EU rules on jurisdiction and applicable law in insolvency proceedings (i.e. the Insolvency Regulation)[74]. The introduction of the AECE in the national framework would leave MS' national insolvency law unaffected[75]. In particular, because, as said, the AECE is not a new security right, this option would be without impact on MS' existing ranking of creditors' rules and principles (*e.g. par conditio creditorum* and *pari passu* principles).

Legal instrument – The legal instrument envisaged in option 2 would be a **minimum harmonisation Directive** which would provide key features of national extrajudicial enforcement procedures, while granting sufficient discretion and flexibility to Member States as regards the way the new requirements would be implemented into national laws.

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[71] http://ec.europa.eu/information_society/newsroom/image/document/2016-48/proposal_40046.pdf
[72] Under Art 6 , COM (2016) 723 "debtors (…) may benefit from a stay of individual enforcement actions if and to the extent such a stay is necessary to support the negotiations of a restructuring plan".
[73] Art 1, COM (2016) 723
[74] http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A32015R0848
[75] See among others: *Security Rights and the European Insolvency Regulation* - JUST/2013 - http://3x6woj16vh2x3wjgt851bs9f.wpengine.netdna-cdn.com/files/2014/07/SREIR-Roman-Legal-Systems.pdf

9.2.4 Option 3 - Creation of a new EU security right together with a fully harmonised extrajudicial enforcement procedure

This option would consist in establishing a new EU security right which would be added to the already existing security rights available in Member States. This option, labelled ALS (Accelerated Loan Security) would provide for the creation of a new EU security right which would be enforced through a fully harmonised extra-judicial enforcement procedure. If such security was granted to the bank by the borrower, this security would serve as the basis for a swift enforcement of the security right in the event of debtor's default. The ALS would be uniformely available in the EU and would require a high level of harmonisation of Members States' key legal provisions such as civil, commercial, restructuring, and insolvency laws, and public law (most of which are left to national discretion/rules in option 1 and option 2).

The EU common provisions of the ALS would focus on five areas:

1) Nature – The ALS would be a new EU security right to be added to the types of security rights existing at national level. The ALS would also include a specific (i.e. repossession) out-of-court enforcement procedure. The ALS would be voluntarily agreed in writing. Even if the use of the ALS is agreed by the contractual parties, it would not be mandatory for the bank to use the fast enforcement mechanism of ALS where the borrower is in default. It will be up to the bank to assess whether or not it wishes to use this instrument.

2) Procedural features – The ALS would be enforced out-of-court through appropriation.

Out-of-court enforcement by means of appropriation which consists in the reposession of the assets would work as follows: once the debtor is in default in fullfilling its obligations as set up in the loan agreement, the ownership of the movable or immovable assets, given as a guarantee by the debtor, to the bank would be the transferred to the bank/other creditor where the original loan has been transferred by a bank to a third pary. Having acquired the ownership over the encumbered assets, the bank could therefore be in the position to foreclose the collateral (i.e. to execute directly the security right) via an out-of-court proceeding, without any judicial intervention. Concretly, in such a case the bank would have the right to directly recover value from the collateral either by selling the assets (as a common private party-seller) or by keeping them.

A key consideration in the case of appropriation is asset valuation. Valuation is important for two main reasons: the value of the asset, as establihed following the valuation would impact how much the creditor would recover of its outstanding claim againt the borrower, but also whether or not the borrower should be paid back the difference between the amount recovered and the claim.

In order to ensure that the creditor will not take undue advantage from the repossession, the ALS foresees a valuation procedure by the appointment of a third-party independent expert. It is key that the valuation process be carried out independently by an expert and it be done in a way to ensure a transparent and fair process. The parties would have to agree on the appointment of an independent expert to evaluate the collateral. This option would provide for a set principles and rules which would govern the valuation of collateral for the purpose of its enforcement. This should mitigate the tension between possible diverging interests between the creditor and the borrower. It would be required, for example, that the valuation of the asset be independent meaning that, in principle, it would not be possible that the valuation is carried out by one of the contractual parties (i.e. the creditor); and that the valuation be fair and realistic.

The valuation requirement would be set out in the security right or in the loan contract. In both cases, the (minimum) value of the assets should be established *ex ante* (before the repossession of the collateral) and following common criteria. Whenever the valuation or the liquidation of the assets leads to a value higher than the debt amount, the secured creditor should pay back the difference to the borrower.

Similarly to Option 2, the debtor should be able to contest and raise objections to the use of the ALS and the valuation of the asset used as collateral for the purpose of the appropriation. This would mean that the debtor may contest the execution procedure and to appeal to a judicial court in relation to the use of the ALS, including as regards the valuation of the asset. Member States would be given discretion to decide on the suspensive effects of such objections or appeals on the enforcement of the ALS. Finding the right balance between the power of the judicial court and such extrajudicial enforcement should be left to Member States.

As regards a situation where, as a consequence of the appropriation of asset (regardless of whether the creditor decides to sell or keep the encumbered assets), the creditor recovers more value than the outstanding debt of the borrower, the creditor should have the obligation to pay back to the debtor the difference between the value of the asset (as per the estimated value in case of appropriation) and the amount owed as at the time of execution of the ALS. In case of negative difference the possibility of *datio in solutum* / debtor's discharge (i.e. debtor not liable for the shortage) should be addressed at national level, together with any other solution consistent with Member States legal framework.

Given that this option introduces a new security right in Member States' legal frameworks, it may be necessary to adapt some national rules such as civil, commercial, restructuring, insolvency laws, and public law. For example, the creation of an ALS would have an impact on the hierarchy/ranking of creditors in ordinary enforcement proceedings. Those rules would need to be changed in order to take into account the establishment of the ALS in particular with regards to the place the ALS would get in the ranking of creditors. This has an impact, for instance, in a case where more than one security right has been granted over the same asset(s), because it would change the order of satisfaction of concurring creditors. Such rules have been traditionally governed by Member States' laws.

3) Publicity requirements – Given the importance of transparency to make third parties aware that an asset is charged by a ALS, in particular in the case of real estate, when the use of an ALS is foreseen by agreement between a bank and a corporate borrower, third parties should be informed about the right of creditor/bank to enforce the loan by means of an out-of-court enforcement.

In order for the banks to take full advantage of the creation of a new security right and be able to enforce it on a cross-border basis, the establishment of an ALS under this option would be accompanied by the creation of a centralised EU register. Such an EU register, which would be an electronic one, would collect all information about the loan agreements equipped with the ALS. This should ensure full transparency on the entities which would be able to potentially use of the out-of-court enforcement procedure for the ALS.

4) Transferability – This feature would ask Member States to ensure that the security right itself as well as the right to extrajudicial collateral enforcement, are transferable, in order to foster the development of secondary markets for NPLs. In particular, where a loan equipped with ALS is sold by the bank to a third party, that third party (which may or may not be a credit institution) would be able to use ALS in case of borrower's default (under the same conditions as the originating bank).

5) Restructuring and insolvency – As for AECE, the ALS will remain consistent with and complementary to the Commission proposal on preventive restructuring and second chance. Once a restructuring proceeding starts and the "stay" provision is granted (under art. 6 of COM proposal or a similar national law provision), Member States will be required to ensure that the enforcement mechanism of the ALS is suspended. The ALS will in principle not interfere or have minimal impact on national rules and principles of pre-insolvency and insolvency proceedings, which in case of conflict would prevail to the extent granted by national law. However given the fact that the ALS is a new security right it would have an impact on the ranking of creditors in insolvency law.

The legal instrument – The legal instrument envisaged in option 3 would be a **Regulation** which will ensure that a new EU security right with full harmonisation of the extrajudicial enforcement mechanism attached to it for secured loans would be available to all banks (and investors in case of loan disposal) operating in the EU.

9.3 Options discarded at an early stage

9.3.1 Option 4 - EU out-of-court enforcement mechanisms through an alternative regime

Under this option, a legislative instrument (a Regulation) would establish a uniform extrajudicial procedure for collateral/collateral enforcement through a set of common rules, thereby establishing a 29th regime in the European Union with identical features in all MS to work along already existing national procedures. That is to say that this EU-level regime would co-exist with and complement national procedures (which would not be modified as envisaged in the three options above). This option would ensure a level playing field for banks and would benefit cross-border collateral enforcement cases as there would be a unique set of rules available across the EU. Two sub-options could be imagined as follows:

[AECE-type 29th regime] – Upon agreement between banks and corporates or entrepreneurs, the parties could use an EU out-of-court collateral enforcement regime as a possible alternative to their existing national mechanisms for out-of-court enforcement, if any, or as an instrument to provide their existing security rights with this effective enforcement proceeding (as per option 2 - AECE-type). For certain national security rights (*e.g.* rights *in rem* such as pledges and mortgages) that are in the scope of the EU regime, there could be a potential concurrence of national and EU extrajudicial procedures. This option is therefore discarded as

it would create legal uncertainties for market players in those Member States as regards to which out-of-court mechanisms (the EU or national ones) would prevail in case of conflicts. This additional complexity might be counterproductive in particular in those Member States which have national extrajudicial enforcement procedures that work well.

[*ALS-type 29th regime*] – Upon agreement between banks and corporates or entrepreneurs, the parties could use the EU new security right equipped with a fully harmonised extrajudicial enforcement procedure regime as a possible alternative to their existing national security rights (as per option 3 – ALS-type). This option is therefore discarded as it is reasonable to expect that well-functioning markets will have no incentive to choose a 29th regime instead of their functioning one. Moreover, such a Regulation would have a substantial impact on private and/or public law (including property law and insolvency law – ranking of creditors, registration, publicity). Since Member States would be given flexibility on how they integrate the ALS into their legal framework, i.e. by allowing them to decide on the ranking of ALS in the creditor hierarchy, this option might lead to divergent approaches in the Member States. Therefore, to provide a 29th regime requires the harmonisation of all such legal frameworks which goes far beyond the policy objective of this initiative.

9.3.2 Option 5 - Harmonisation of judicial collateral enforcement procedures

The strengthening of the secured creditors' ability to enforce collateral might also be achieved by ensuring that all Member States have common, effective, and transparent and legally certain judicial enforcement procedures. This would strengthen the efficiency of the collateral judicial enforcement across EU and to a large degree dispel with the need for any alternative out-of-court mechanism. However, this option should be discarded as harmonising judicial enforcement regimes would be much more invasive than any of the other options analysed above. It would touch upon, inter alia, civil procedure and constitutional law issues which it would not be desirable, nor feasible, to harmonise. In addition, harmonisation of the enforcement law on the books would not necessarily go all the way towards more efficient enforcement regimes since judicial capacity is part of the equation. Out-of-court enforcement is a mechanism available already in a certain number of Member States to address the problem that judicial enforcement can be lengthy for a variety of reasons. Given that this less invasive solution is available, harmonising the entire system of enforcement law would be disproportionate to tackle a specific problem, such as quicker value recovery from collateral as outlined in this IA. This option would go far beyond the policy objective of this initiative.

10 What are the impacts of the policy options?

10.1 Option 1 - Non-regulatory action based on existing international harmonisation initiatives of extrajudicial collateral enforcement procedures

10.1.1 Pros and cons

Table 2 – Pros and cons – Option 1

Pros	**Cons**
Minimise implementation cost as a non-binding instrument would leave the highest degree of discretion to Member States avoiding possible disruptions of national regimes that work well.	Highest risk that some Member States do not follow the initiative.
Potential to decrease administrative costs for public authorities, the intervention of any public authority in the enforcement process, such as notary or bailiff, would be at the expense of the parties.	Potential heterogeneity of approaches which could continue to inhibit cross-border collateral enforcement and lending, and would continue exposing banks to a higher risk of accumulation of NPLs

More details can be found in annex 6.

10.1.2 Impact on key stakeholders

The impacts on key stakeholders are assessed against the baseline scenario. Some of the identified types of impacts below are common to the three options with, however, a varying degree of effects on stakeholders. With regards to option 1 the expected impacts are foreseen to be quite marginal given the uncertainties linked to how many Member States would follow the recommendation and the approach they would take to implement the recommendations. National measures aimed at enabling banks to recover value from secured loans through extrajudicial enforcement, and thus aimed at preserving financial stability would not be as effective as EU rules in ensuring financial stability at EU level, given the likelihood of Member States focusing on domestic issues to the expense of consistency between various national regimes. On the contrary, national measures might distort competition and affect capital flows by establishing divergent rules.

Table 3 – Positive and negative impacts, stakeholder type – Option 1

Impact on key stakeholders	**Corporate (including SME) as borrowers**	**Secured creditors including investors**	**Other commercial creditors (unsecured, junior, suppliers, etc..)**	**Member states (competent authorities and public creditors)**
Positive	≈ /+ (reduced borrowing costs and increased supply of finance but only marginally)	≈ /+ (increased recovery rates and avoidance of NPL accumulation but only marginally) ≈ /+ (reduced bid/ask spreads for third party	≈ (the maximisation of value recovery by secured creditors should benefit other creditors in insolvency but only in certain cases)	≈ /+ (higher banking stability, better economic sentiment and freeing up of courts capacity)

		investors but only marginally)		
Negative	≈ /- (unsustainable companies will cease operations quicker)	≈ /- (increased reputational risk)	≈ /- (suppliers of unsustainable companies will lose their client quicker)	≈ /- (implementation costs)

Notes: ++ = strongly positive; + = positive; -- = strongly negative; ≈ = neutral/marginal;? = uncertain; n.a. = not applicable;

Please refer to annex 6 for a more detailed description of the impacts (both qualitatively and quantitatively). Also section 8.1 provides a summary of the key quantifications.

10.1.3 Stakeholders' views

The group of legal experts did not include the recommendation among the options which should be used to establish a coherent system for the out-of-court collateral enforcement. A minimum harmonisation directive or a regulation has been the envisaged option for the expert group (see sections 6.2.3 and 6.3.3). Preliminary views expressed by some business associations included some support for a recommendation which would allow for a targeted approach to incentivise Member States without out-of-court enforcement procedures to establish such procedures. Some Member States also invited the Commission to consider a recommendation as a way to promote best practices among Member States with existing mechanisms and to invite Member States without such mechanisms to remedy the situation. This would avoid any disruptions in the Member States that have such systems. None of the categories of stakeholders who responded to the public consultation suggested the use of a recommendation. The overall stakeholder's support for option 1 is then assessed as low/medium. More could be found also in section 7.

10.2 Option 2 - Minimum harmonisation of extrajudicial collateral enforcement procedures

10.2.1 Pros and cons

Table 4 – Pros and cons – Option 2

Pros	**Cons**
A common set of key principles and rules would contribute to ensuring a level-playing field for banks across the EU providing more legal certainty in a cross-border context while	Implementation of the rules in divergent ways, given the discretion which is left to them on a number of areas[76]. The level of divergence is however lower compared to

[76] As explained in section 9.2.3

minimising the impact on Member States' private and public laws.	option 1
Provide flexibility to Member States as regards the implementation into national frameworks while establishing a common set of rules reducing the implementation costs required by the directive. The great variety of features of Member States' private and public laws require a certain level of flexibility for Member States to implement an EU framework on out-of-court enforcement to enable them to apply it in a suitable fashion.	This option would not create the highest level of effectiveness and legal certainty as regards out-of-court collateral enforcement procedures (as opposed to option 3 which would consist in full harmonisation).
Potential decrease of administrative costs for public authorities, as the intervention of any public authority in the enforcement process, such as notary or bailiff, would be at the expense of the parties	

More details can be found in annex 6.

10.2.2 *Impact on key stakeholders*

The impacts on key stakeholders are assessed against the baseline scenario. Some of the identified types of impacts below are common to the three options with however varying degree of effects on the stakeholders. With regards to option 2 the impacts are expected to be somewhat significant given the obligation for Member States to implement AECE and the level of achieved harmonization across the EU.

Table 5 – Positive and negative impacts, stakeholder type – Option 2

Impact on key stakeholders	Corporate (including SME) as borrowers	Secured creditors including investors	Other commercial creditors (unsecured, junior, suppliers, etc..)	Member states (competent authorities and public creditors)
Positive	+/++ (reduced borrowing costs and increased supply of finance including cross-border)	+/++ (increased recovery rates and avoidance of NPL accumulation and more cross-border opportunities) +/++ (reduced bid/ask spreads for third party investors)	≈ (the maximisation of value recovery by secured creditors should benefit other creditors in insolvency but only in certain cases)	+/++ (higher banking stability, better economic sentiment and freeing up of courts capacity)

Negative	- (unsustainable companies will cease operations quicker)	- (increased reputational risk)	- (suppliers of unsustainable companies will lose their client quicker)	≈ /- (implementation costs)

Please refer to annex 6 for a more detailed description of the impacts (both qualitatively and quantitatively). Also section 8.1 provides a summary of the key quantifications.

10.2.3 Stakeholders' views

Table 6 – Shareholders' views – Option 2

Stakeholders	View	Reason
Banking industry	+	The banking industry is rather supportive of the establishment of an out-of-court enforcement procedure across the EU. They however expressed concerns as to: (i) the suspension of the mechanism during restructurings and insolvency proceedings arguing that this limitation would weaken the value of security and would discourage banks from supporting restructuring efforts for a debtor's potentially viable business; and (ii) a rule which would allow full discharge of the borrower[77]. Some respondents underlined that the threat of a possible collateral enforcement can in itself be persuasive and reduce moral hazard of debtor. In general banks do no automatically wish to enforce the collateral and they wish to keep the freedom of choosing to enforce the collateral or not (which will be assured by the voluntary nature of the mechanism).
Investors and loan servicing companies	+	They stressed the importance of allowing for a transfer of this mechanism to investors to help the development of secondary markets for NPLs. They expressed doubts as to the full effectiveness of this mechanism if it is switched off during insolvency and to the full discharge of the debtor which – it is argued – might discourage banks as the risk of a reduction in price of the collateral would be borne by the bank while an increase would only benefit the debtor.

[77] Banks argued that this could encourage borrowers to act irresponsibly and increase speculative behaviours especially when the recovered value from the sale of assets is lower than the value of the outstanding amount.

Government and public authorities	+/-	Some Member States expressed doubts that such an instrument can significantly accelerate the enforcement process in those Member States where procedures carried out by courts are already handled in a short period of time. One Member State argued that while out-of-court procedures can be beneficial, the solution to the NPL problem lies mainly on strengthening the judicial procedure across the EU. Two out of the four Member States which currently do not have out-of-court enforcement procedures for collateral (DK and MT) support the objectives of the Commission to introduce such mechanisms for loans granted to companies and entrepreneurs (with the exclusion of consumers and the primary residence of a corporate owner), but insist that out-of-court enforcement procedures should not interfere with the Commission's proposal on preventive restructuring and second chance, and with Member States' insolvency laws.
Law firms	+	These entities see merit in EU action to establish a common enforcement procedure because this would provide banks with certainty in respect of process and timing to enforce security.
Consumer associations, NGOs, and private individuals		No view provided
Business associations	+	No formal official position, the representatives agreed in their personal capacity. The main benefit mentioned was a reduction in risks and hence a decrease in lending rates in (particular SMEs) arguing that the benefit will be higher in MS without or inefficient out-of-court mechanism especially in those MS with current high level of NPLs. The need for safeguards for debtors would inevitably be priced in by the lenders.
The expert group	++	Sees merit and is supportive of an EU directive on harmonized rules on out-of-court collateral enforcement. The expert group insisted on the need for a swift and transparent procedure, given that existing mechanisms are often not used in practice because they do not ensure an expedited process to allow for value recovery (i.e. process leading to selling assets much below market value, which is neither satisfactory for banks, nor for the borrowers).

The overall stakeholder's support for option 2 is assessed as medium. More could be found also in section 8 and in Annex 6.

10.3 Option 3 - Creation of a new security right together with a fully harmonised extrajudicial enforcement procedure

10.3.1 Pros and cons

Table 7 – Pros and cons – Option 3

Pros	**Cons**
Banks in all Member States would benefit in a uniform way from the possibility to recover value from secured loans, should they choose the ALS. This would increase legal certainty and predictability. From a single market perspective, banks would no longer have to invest time and bear costs related to assessing the way in which they can recover value on a cross-border basis.	Major impact on Member States' legal frameworks due to integration of a new security right. This requires adjustment and alignment of numerous areas of their national legal systems (*e.g.* property law, private and public law, registration rules, insolvency laws etc.).
Easier out-of-court enforcement in case of ALS given the legal certainty it offers as regards the ownership of the collateral at the moment of borrowers' default. Because the creditor is the owner from the signing of the loan agreement, the creditor can take actions to take swiftly the possession of the collateral.	The hierarchy of creditors in pre-insolvency and insolvency procedures would need to be altered in some Member States which is highly politically sensitive.
	Member States would need to ensure that current formalities and publicity requirements for existing security rights are modified to take into account the establishment of an EU register for the publication of ALS
	Potential significant compliance costs, especially as regards the implementation of a new security right, the relevant formalities/publicity requirements, training of the legal professions in relation to the application of a new security right, and for the implementation of a fully harmonised extrajudicial enforcement procedure.

More details could be found in Annex 6.

10.3.2 Impact on key stakeholders

The impacts on key stakeholders are assessed against the baseline scenario. Some of the identified types of impacts below are common to the three options with however varying degree of effects on the stakeholders. With regards to option 3 the impacts are expected to be significant given the obligation for Member States to implement ALS and the high level of achieved harmonization across the EU.

Table 8 – Positive and negative impacts, stakeholder type – Option 3

Impact on key stakeholders	**Corporate (including SME) as borrowers**	**Secured creditors including investors**	**Other commercial creditors (unsecured, junior, suppliers, etc..)**	**Member states (competent authorities and public creditors)**
Positive	++ (reduced borrowing costs and increased supply of finance including cross-border)	++ (increased recovery rates and avoidance of NPL accumulation and more cross-border opportunities) ++ (reduced bid/ask spreads for third party investors)	≈ (the maximisation of value recovery by secured creditors should benefit other creditors in insolvency but only in certain cases)	+/++ (higher banking stability, better economic sentiment and freeing up of courts capacity)
Negative	- (unsustainable companies will cease operation quicker)	- (increased reputational risk) - (the repossession of the assets might entail liability and other risks)	- (supplier of unsustainable companies will lose their client quicker)	- (change in creditors ranking)

Please refer to annex 6 for a more detailed description of the impacts (both qualitatively and quantitatively). Also section 8.1 provides a summary of the key quantifications.

10.3.3 Stakeholders' views

Table 9 – Stakeholders' views - Option 3

Stakeholders	View	Reason
Banking industry	+/-	This group sees the potential benefits of an ALS but only if the new security right remains enforceable in insolvency/pre-insolvency procedures, although it is recognised that such an advantage for secured creditors cannot be integrated into national insolvency regimes without significant disruptions. Moreover, because of

		inherent risks associated with possessing the assets (especially mortgaged real estate), all respondents from the banking industry (barring one) said that it would be preferable that banks be granted authority to sell instead of becoming owner of the assets in the case of an out-of-court enforcement procedure under the form of appropriation.
Investors and loan servicing companies	+/-	It is important that the ALS be transferrable to investors. Otherwise this would create an obstacle for the development of secondary markets for NPLs. In general the views of investors and loan servicing companies are aligned with those of banks on the need to provide the banks the power of attorney for the sale of asset instead of transferring the property.
Government and public authorities	--	Government and public authorities not supportive as they stated that the creation of an independent European security instrument in addition to the existing security interests under national law could be seen as a sensible approach only if it could be integrated into the national legal orders (in particular property law and enforcement law) which however differ substantially in MS according to their respective legal traditions and economic structures. Government and public authorities also underlined the uncertainties associated with the acquisition and realisation of the collateral as foreseen in the ALS especially in the case of real estate where a large number of burdens are associated with ownership entailing expenses, costs and risks.
Law firms	+/-	See the potential positive effects of ALS in avoiding accumulation of NPLs and improving lending as lenders will be equipped with pre-determined exit routes; however they caution that the appetite to enforce through an ALS would be lender-specific and voluntary hence limiting somewhat the potential effects. Moreover it is argued that the best value is rarely attained by forcing the repossession of asset as this leaves the bank with an asset which does not provide any productivity between repossession and sale.
Consumer associations, NGOs and private individuals	+/-	Provided comments on the features of the ALS: i) compulsory setting of a (minimum) value of the assets in advance by an independent expert; ii) a mandatory duty to pay back the difference to the borrower once the asset is sold iii) the mechanism trigger should be subordinated to a request by the bank to the borrowers for a revised business plan and possible restructuring – only in case of a failure to comply with this request the bank should be able to trigger the mechanism.
Business associations		No view

<u>The expert group</u>	--	Against creating a new security right (ALS) accompanied by an out-of-court enforcement mechanism. According to the experts, establishing a new security right would interfere too much with national legal systems and would be extremely complex insofar as very technical provisions are closely linked to national rules on security law, transfer of ownership, publicity requirements, and ranking of creditors in insolvency. Experts also pointed to the little value-added of establishing a new security right because the real problem does not rely in the absence of security rights in the Member States, but in the lack of efficient out-of-court mechanisms for enforcing existing security rights.

The overall stakeholder's support for option 3 is assessed as low. More could be found also in section 8.1 and in Annex 6.

11 How do the options compare?

The following policy option matrix (*Table 10*) summarises each of the available options (including the baseline) along with the related policy areas to be addressed (rows the former and columns the latter). Each cell specifies the level at which each area will be settled.

Table 10 – Key characteristics of the policy options

Options	**Security rights**	**Out-of-court enforcement mechanisms**	**Nature and scope**	**Procedural features**	**Transferability to third parties**	**Publicity requirements**
Baseline	National - existing security rights	National - heterogeneous situation with the three out-of-court mechanisms (private sale, public sale and repossession) not all available in the MS. Some MS have only 1 procedure (depending on assets used as collateral), other have 2-3 procedures, while 4 MS do not have any.	National - heterogeneous situation as national systems are applicable sometimes to consumers as well as business loans and different types of collateral (moveable/immovable including primary residence)	National - heterogeneous situation as national systems have different features given the interlinks with private and public laws which differ between MS	National - different national rules	National - different national rules
Option 1	National - existing security rights	National - more homogeneity as MS recommended to have in place at least one out-of-court enforcement mechanism based on high level principles set at EU level	National - more homogeneity as MS recommended to exclude consumers and primary residence of business owners from the scope	National - more homogeneity as MS recommended to ensure that the procedural features comply with high level principles set at EU level	National - more homogeneity as MS recommended to ensure that the extrajudicial mechanism would be available to third parties in case of transfer of the loan	National - More homogeneity as MS will be recommended to inform other affected parties about out-of-court enforcement mechanism.
Option 2	National -	EU - MS required to	EU - exclusion of	EU - high level	EU - requirement	EU - MS required to

	existing security rights	have in place a private sale mechanism or, alternatively, any of the two other out-of-court mechanisms	consumers and primary residency of business owners from the scope	principles of fairness, transparency and efficiency for private sale as preferred option (and for the other two out-of-court mechanisms as fall-back options) National - specific details of the procedure	that the AECE is available to third parties in case of transfer of the loan	inform other affected parties about AECE National - The modalities will be left to MS depending on the type of security AECE is attached to
Option 3	EU - creation of a new security right	EU - The repossession mechanism will be the attached to the new security right	EU - exclusion of consumers and primary residency of business owners from the scope	EU - repossession of assets upon default and asset valuation procedure via 3rd party independent expert	EU - requirement to have the ALS available to 3rd parties in case of the transfer of the loan	EU - Other affected parties will be informed about the ALS through an centralised EU online register

Table 11 below summarises the extent to which the options are **effective, efficient and coherent**. Effectiveness is mapped against the objectives set out in section 8. The respective scores are attributed on the basis of the detailed analysis in the sections (see "pros and cons" and "impact on key stakeholders") in particular:

- **Effectiveness** – option 3 is the most effective in reaching the policy objectives followed by option 2 and option 1. This is because option 3 would achieve the highest level of harmonization (hence the highest benefits in terms of recovery rates, cheaper and more lending, cross-border aspects, etc..) whereas on the other side the benefits achieved by option 1 are limited given the uncertainties linked to how many Member States would follow the recommendation and the approach they would take to implement the recommendations. Option 2 sits in between with however expected benefits closer to option 3 than option 1;

- **Efficiency** – while option 3 would bring the most in terms of harmonisation and true uniform out-of-court enforcement procedure, this would only be achieved at major implementation and compliance costs as regards the implementation of a new security right, the relevant formalities/publicity requirements, training of the legal professions in relation to the application of a new security right, and for the implementation of a fully harmonised extrajudicial enforcement procedure; for option 1 the somewhat limited benefits will be achieved at the lowest cost as this option would incur minor implementation cost (as Member States will decide how and in what way modify their system according to the recommendation) and no major compliance costs (as the mechanism will be attached to existing security rights); option 2 would also have no major compliance costs (as the mechanism will be attached to existing security rights) but would imply higher implementation costs as (some) Member States will need to modify somewhat their national systems to comply with the principles set by the minimum directive;

- **Coherence** – while option 3 would bring the most in terms of harmonisation and a true uniform out-of-court enforcement procedure, it would have a major impact on Member States' legal frameworks and as such it scores the poorest; option 1 on the other hand leaving any adjustment to the discretion of Member States has the advantage of avoiding any possible disruption to national regimes that currently work well - however given the substantial divergences between Member States' private and public laws, it is highly unlikely that Member States individually would be able to ensure the overall coherence of their legislation with other Member States' out-of-court enforcement mechanisms (so the balance between national and EU coherence is assessed as neutral); finally option 2 would provide for a common set of rules, while at the same time granting some level of discretion to Member States as regards the best way to include such a mechanism into their legal frameworks hence minimizing the impact on Member States' private and public laws.

Table 11 – Benchmarking policy options

Objectives / **Policy option**	**EFFECTIVENESS**			**EFFICIENCY**	**COHERENCE**
	Reduce future levels of secured NPLs in banks' balance sheet	Facilitate more lending to corporates and at lower costs, including on a cross-border basis	Enable secured creditors to effectively and swiftly recover collateral value in a standardized way across the EU when business borrowers default on secured loans		
Baseline scenario No policy change	0	0	0	0	0
Option 1	≈/+	≈/+	≈/+	+/++	≈
Option 2	+/++	+/++	+/++	+	+
Option 3	++	++	++	--	--

Notes: ++ = strongly positive; + = positive; -- = strongly negative; ≈ = neutral/marginal;? = uncertain; n.a. = not applicable;

In terms of stakeholders' support, while there is consensus among stakeholders of all categories as regards the policy objectives, the level of support for the different options varies among the different categories of stakeholders:

- Option 3 received little support across the whole stakeholders' spectrum mainly given to the fact that establishing a new EU security right would interfere too much with national legal systems and would be extremely complex insofar as very technical provisions are closely linked to national rules on security law, transfer of ownership, publicity requirements, and ranking of creditors in insolvency – the overall stakeholders' support is then assessed as low;
- Option 2 was the one supported the most especially by the banking industry, third party investors and some Member States which see clear benefits in the establishment of an out-of-court enforcement procedure across the EU. Some however expressed some reservations as regards some of the features of the mechanism (e.g. suspension of the mechanism in restructuring/insolvency procedures) which would impact its attractiveness and efficiency. Business associations also partially supported the option given the expected reduction in borrowing costs especially for SMEs it would entail. However together with some Member States they argued that the usefulness of the system would be higher in those Member States without such a system or with an inefficient system. Finally the expert group considered option 2 as the least intrusive option while at the same time reaching a meaningful level of harmonisation across the EU – the overall stakeholders' support is then assessed as medium;
- Stakeholders' support for option 1 sits between the other options as it received some support from the business associations and some Member States as it would allow for a targeted approach to incentivise Member States without out-of-court enforcement procedures to establish such procedures and would avoid any disruptions in the Member States that have with such systems – the overall stakeholders' support is then assessed as low/medium.

Table 12 – Effectiveness/efficiency/coherence and stakeholder support of the policy options

Option	**Effectiveness/efficiency/coherence**	**Stakeholders support**	**Level of ambition/challenge**
1	3	Low/medium	low
2	6.5	medium	medium
3	2	low	high

Based on the above, the retained option is option 2 (minimum harmonisation of extrajudicial collateral enforcement procedures). It achieves the policy objectives while maximising the benefits/cost ratio. This option also strikes the right balance between achieving coherence at EU level and leaving sufficient flexibility to Member States to implement the new rules in a way which minimises impact on their national private (civil, commercial), property law and public laws, given the multiple interlinks between this initiative and Member States' private and public laws (hence it is found to be the most proportional among the three options considered). Option 2 also strikes the right balance stakeholders support and level of ambition.

Finally, in line with the problem driver 1, this option would achieve the operational objective of assuring that the existence of out-of-court enforcement mechanism governed by the same principles in the whole EU.

12 The preferred option and its overall impacts

As discussed in the previous section, the comparison of options led to the selection of Option 2 as the preferred option. The following subsections assess more in detail its likely economic, social and other impacts.

12.1 Economic impacts

The primary function of security is the reduction of the risk of losses of a credit provider with respect to performance of a debt, i.e. debt service (repayment or interest payments) in the case of loans and non-payment in the case of sale credit. The degree to which a secured transactions law can perform a risk-reducing function is mainly dependent on two determinants: the legal efficiency of the security interest provided under a national law and the value of collateral upon enforcement. As discussed throughout this impact assessment, improving the efficiency of out-of-court collateral mechanisms can improve both aspects hence reducing the risk of a creditor's losses. If this is clearly a benefit from the point of view of the creditors (e.g. higher recovery rates – for the quantification see below), it can also lead to a number of economically beneficial effects for the debtor such as[78]:

- a reduction of the interest rate (as is evidenced by the difference in interest rate between secured and unsecured credit – for the quantification of the expected reduction see below);
- an increase of the credit amount and a decrease of the borrower‘s equity contributions (although the determining factor for the credit amount will be the borrower’s ability to repay the credit from ongoing and expected future income, the security will impact the credit amount in many ways, e.g. by allowing lower amount of equity to be provided by the debtor and thus a larger amount of debt);
- an extension of the credit’s tenor;
- an improvement of other terms and conditions (e.g. less stringent financial cover ratios in loan agreements such as the debt service cover ratio).

[78]As also explained in "The EBRD’s Model Law on Secured Transactions and its Implications for an UNCITRAL Model Law
on Secured Transactions" – Jan-Hendrick Rover 2010

Moreover, security has positive effects[79] on the whole economy if the risk reduction is achieved efficiently *inter-alia* through expedite extra-judicial collateral mechanisms. Firstly, there is an investment effect in the sense that security interests support investments in an economy because they increase the amount of credit available. Furthermore, secured transactions lead, not only to investments, but to the right investments. They have an allocation effect in that secured transactions support an economically efficient allocation of credit (which is a scarce economic resource). If security interests are created, credit is extended to creditworthy borrowers, i.e. borrowers which are able and prepared to provide security interests in valuable assets. Security is thus an integral element of a financial system since it distinguishes between projects which should be financed and projects which should not.

It could be claimed that the decrease in the risk of losses of the security holder is achieved at the expense of third persons whose risk of losses is increased. However, as explained above, security mobilises financing and sometimes it is the only way to mobilise financing at all. In that respect, companies (SMEs in particular) already use secured borrowing extensively to finance their long-term projects. The introduction of AECE could help companies that previously could not get any financing at all to get a secured loan. Also, the AECE is not expected to result in more foreclosures but in faster foreclosures, in particular for those businesses with an unsustainable business model and which were going to become insolvent anyway. The AECE is a mechanism that will be attached to security rights which would have permitted the creditor to enforce them anyhow, with the difference that the AECE will allow the creditors to enforce in a swifter manner.

Below one can find a tentative quantification of the economic benefits both for creditors (higher recovery rates) and business borrowers (lower borrowing costs) carried out by the Commission services (see more details in annex 4).

Taking the tables below one by one:

- The unweighted average modelled recovery rate on secured loans could increase by up to 10 percentage points in the preferred option (AECE) compared to the baseline[80];
- In a stylised NPL crisis scenario, the future stock of around EUR 463 bn of new corporate secured NPLs would result in a loss/need of overall provisioning for the banking sector of EUR117 bn;
- With the use of AECE, the recovered amounts could increase by up to EUR 8 bn i.e. reducing the total loss by about 7%;
- The increase in recovery rates is expected to translate into a reduction of borrowing costs for companies. A more conservative lower bound estimate for the effect of AECE on lending rates would be an average reduction of lending rates by 10.4 bp., leading to annual savings for borrowers of up to EUR 562M in the medium run. The

[79]Idem

[80] The increase in recovery rates is due to both a higher recovery at the end of the recovery process (i.e. with the avoidance of long judicial procedures, the depreciation of the asset will be contained and the asset can be realised quickly at its market/fair value with the additional advantage of also avoiding the costs associated to the judicial procedures) and on a net present value basis (as the recovered amount will be faster).

higher bound estimate would be respectively 18.4 bp. reduction and annual savings of up to EUR 1000M.

Table 13 - Illustrative quantification of economic benefits

Recovery Rates (%)	Average EU	Increase against baseline	Median EU	Increase against baseline
Baseline scenario	67.7		71.7	
Option 1	69.9	2.2	72.5	0.7
Option 2	78.1	10.4	77.1	5.4
Option 3	78.7	11.0	77.8	6.1

Peak of Secured Corporate NPLs in a stylized future recession	EUR 463 bl
of which SME secured NPLs	EUR 242 bl
of which Non-SME secured NPLs	EUR 221 bl
Assumption about the share of loans using ACE	20% of all non-SME loans 80% of all SME loans
Recovered value in baseline	EUR 346 bl

Estimated extra recovery in stylized future recession	Total (% increase from baseline)	Increase from baseline (EUR bl)	Of which non-SME (EUR bl)	Of which SME (EUR bl)
Option 1	0.6%	2	0.4	1.6
Option 2	2.3%	8.1	1.7	6.4
Option 3	2.6%	9	1.9	7.1

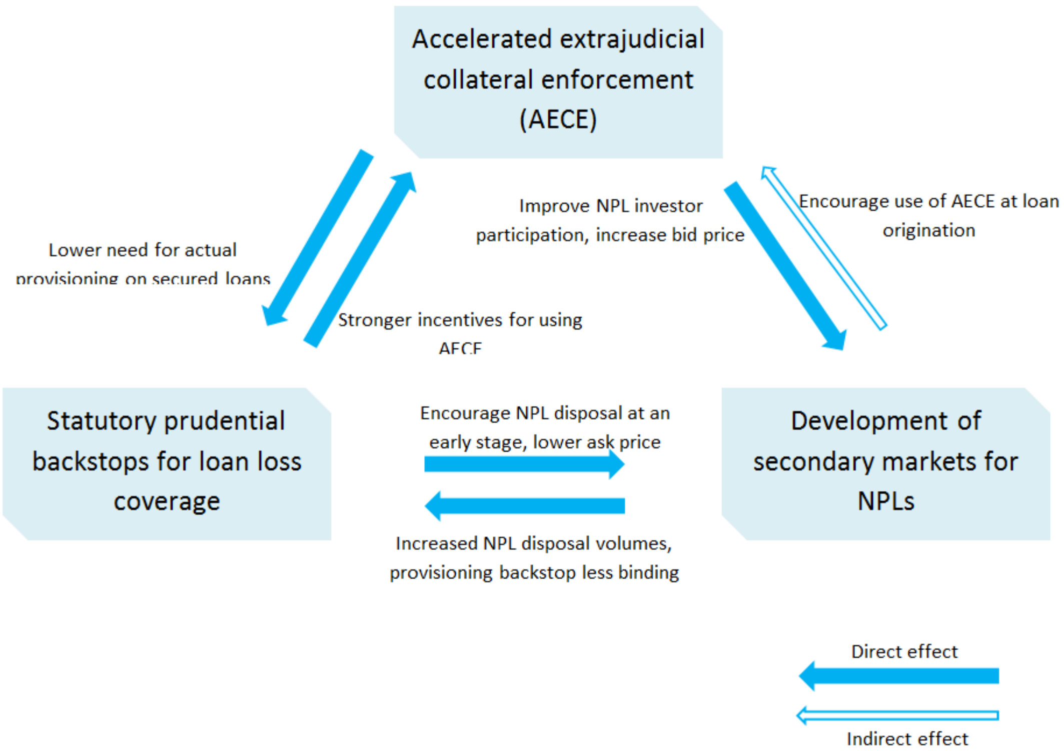
Long term annual interest rate savings for borrowers	Low bound scenario* (EUR M/year)	High bound scenario** (EUR M/year)	Low bound scenario* (decrease rate in basis point)	High bound scenario** (decrease rate in basis point)
Option 1	123	219	2.2	3.9
Option 2	562	1000	10.4	18.4
Option 3	634	1129	11	19.6

*Regression coefficient between recovery rates and lending rates of 0.01 (Commission services)
** Regression coefficient between recovery rates and lending rates of 0.0178 (AFME)

Box on the enhanced impacts: reinforcement effects between the initiatives of the NPL package

This box assesses the possible reinforcement effects between the three initiatives of the so-called NPL package, namely i) statutory prudential backstops for loan loss coverage; ii) development of secondary markets for NPLs, and iii) accelerated extrajudicial collateral enforcement mechanisms. As is the usual practice, each individual impact assessment gauges the incremental effects of the proposed measure against a no policy change baseline. The underlying idea of the NPL package is, however, that the effects of each initiative will be mutually enhancing. The exact quantification of these feedback effects is a quite complex exercise as it is subject to strong modelling uncertainty. This box hence provides a qualitative description of the feedback channels and their relative strength.

Figure 10 - The reinforcement effects between the initiatives of the NPL package



Effects from Accelerated extrajudicial collateral enforcement (AECE) to other initiatives

As AECE becomes more popular and used by credit institutions, the *statutory prudential backstop* measures would be less binding. Indeed, banks would tend to restructure, recover or dispose of their NPLs earlier and at a higher rate. They would be less affected by the need to increase provisioning as time goes by, as required by the prudential backstops measures.

Given that the AECE feature would follow the NPLs following their disposal to a third party, this would help the *development of the secondary market* by increasing investor participation and thereby its liquidity (NPL demand-side effects). In particular, shorter time of resolution and increased recovery, as expected with AECE, would increase the bid prices. Moreover, the harmonization achieved by AECE would foster development of pan-European NPL investors, further improving market liquidity.

Effects from Statutory prudential backstops to other initiatives

The more costly in terms of higher provisioning it becomes for banks to keep secured corporate NPLs on their balance sheets due to the new prudential backstop rules, the higher the incentives for banks to restructure, recover or dispose of NPLs quicker and earlier, and hence the higher the *use of AECE* directly (by triggering it) or indirectly (by disposing of the NPL to a third party).

Holding NPLs on the balance sheet will become costly over time, providing an incentive for banks to dispose of NPLs on *the secondary markets* at an early stage, when the backstops require less minimum coverage. Once the minimum coverage level required by the backstops becomes more binding, the carrying book value of NPLs will be reduced. Both of these mechanisms would ensure more sellers participation on the secondary market (NPL supply-side effect), thereby reducing the ask price of NPLs.

Effects from the development of secondary markets for NPLs to other initiatives

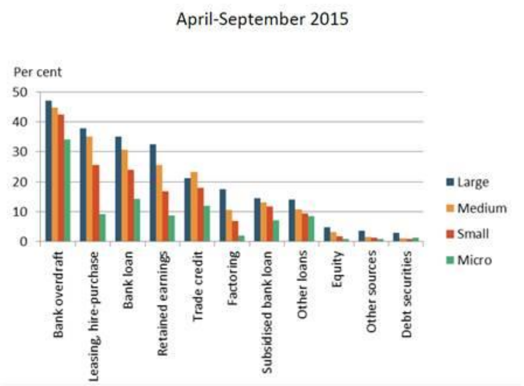
Improved investor participation and better functioning of secondary markets would reduce the bid-ask spread and increase the volume of NPLs that are transferred to third parties. Banks would dispose of NPLs more eagerly and at an earlier stage, therefore the *provisioning backstop* would be less often binding.

With a more liquid and better functioning secondary market for NPLs where investors show appetite for NPLs with the AECE feature, there would be additional incentives for credit institutions to *use AECE* at origination of new loans. This indirect feedback effect would become active once sellers realise that it is easier to dispose of NPLs having the AECE feature to third party investors.

Focus on SME impact

It is generally accepted that SMEs depend on bank financing more than large companies as the latter can finance themselves through other means, such as through capital markets. In particular, as shown in *Figure 11* below, banks provide (in a way or another) the three most popular financing methods for SMEs. Bank overdrafts usually finance company operations and working capital needs. Longer-horizon investments, on the other hand, are usually financed through other means, such as leasing or loans. Bank loans are currently the third financing source with a 30% usage among large enterprises (250+ employees). For microenterprises (lower than 10 employees) they are the second most common financing source, with a 15% usage.

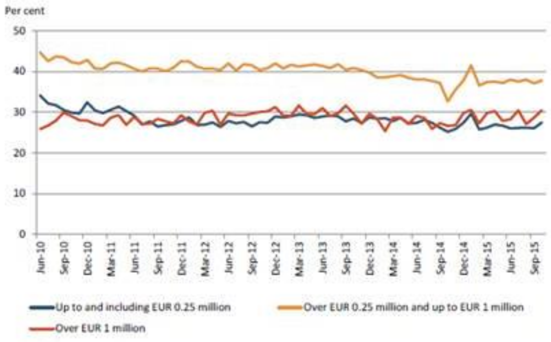
Figure 11 – Type of funding according to firm size



Source: The Commission's SAFE. Note: Size categories are based on the number of employees (1-9: micro; 10-49: small; 50-249: medium; 250+: large). This is expressed as the percentage of respondents that used a given source of finance in the preceding 6 months.

When it comes to secured lending, smaller loans (which are generally associated with SMEs lending) use collateral and guarantees more. In particular, as shown in *Figure 12* below, 40% of the loans with sizes between EUR 250 000 and EUR 1 million have credit protection in the form of collateral and guarantees, compared to 29% for loans over EUR 1 million.

Figure 12 – Share of loans with collateral and guarantees in total loans and advances, by loan size



Source: ECB MFI interest rate statistics

As explained in the impacts sections above the AECE borrowing costs for SMEs are expected to decrease as banks with an effective, expedite way to enforce their collateral can expect both a lower probability of default (since debtor's moral hazard is reduced) and a lower loss given default (as the collateral value will not diminish due to lengthy court procedures). With reduced risks, banks are likely to adjust their loan pricing downwards by virtue of competitive mechanisms. The analysis carried out by the Commission corroborates the findings of AFME (2016) about the likely effects of better recovery rates on loan pricing: an improvement of the recovery rate by 10 pp. is on average associated with lower lending costs by 10 to 18 bps. The Commission work suggests that this pricing effect is stronger for small borrowers (by about 40%). Moreover thanks to the reduction of risks explained above (especially the lower loss given default) more projects which were not able to get financing previously would now become financeable again. As a result, secured lending and the overall supply of finance are expected to increase as well (these volume effects have not been quantified in this impact assessment).

12.2 Social impacts

Safeguards to business borrowers

Given the potential negative social impact of the AECE if applied too widely, a number of measures are envisaged to prevent such impacts, starting with the scope of the initiative, its interaction with the proposed directive on restructuring frameworks, and specific safeguards for borrowers. That is because the use of the out-of-court procedure would accelerate the moment a company/entrepreneur with an unviable business model which faces some difficulties would cease to operate, as compared to a judicial enforcement or restructuring or an insolvency or procedure, even as compared to the most effective regimes.

In order to protect some categories of collateral givers such as consumers, the scope will be limited to business financial transactions (*i.e.* loans between banks and companies and entrepreneurs). Consumers will be excluded from its scope given the potential negative impact on their wealth and patrimony. Even for business borrowers the main residence of the borrower will be excluded from the scope of the AECE. As a matter of fact, a number of existing out-of-court enforcement mechanisms which also include loans to consumers are not used by banks because of reputational risk in case the enforcement of collateral would have a major impact on the overall financial situation of consumers, and thus on households[81]. There is consensus among all categories of stakeholders that an out-of-court enforcement mechanism should be restricted to loans to businesses and corporates, with the exclusion of some sensitive collateral assets such as primary residence of borrower. This would be advantageous on social equity grounds.

To ensure the right balance between extrajudicial power of enforcement given to banks and the **protection of debtors**, the AECE would provide certain explicit debtor's safeguards namely:

(i) thresholds for allowing the use of AECE, aimed at avoiding the abuse of the instrument when the debtor's default cannot be consider as relevant;

(ii) a fair mechanism of valuation and a set of common principles aimed at achieving the maximisation of value recovery value from the private sale of the assets given as guarantee;

(iii) possible *datio in solutum* (discharge) of the debtor – when the value recovered from the asset after the enforcement proceeding is lower than the outstanding debt amount, the debtor could be discharged from the residual repayment obligation;

(iv) the creditor would bear the cost of "enforcement proceeding" in a first stage; the creditor would only be able to recover the expenses only once the assets are sold (thus taking the risk of not being compensated in case the value of the asset is less than the outstanding debt).

In any case, the AECE **will not prejudice the parties' right to access to court in relation to the use of the out-of-court procedure**. This means that the creation of an AECE is without prejudice to the debtor's right to contest the estimated value of the collateral or the execution procedure.

In order to be compliant with existing Member States' principles and rules of private law, including contract and property law, these general measures would keep a certain level of flexibility, while at the same time ensuring that Member States share certain common standards of debtor's protection.

More broadly, as already explained in the stakeholders impacts section, debtors and secured creditors alike would benefit from the following advantages:

- Given that the current high reliance on judiciary enforcement systems has revealed to be costly and slow in some Member States (clogging-up of judicial courts), AECE would serve as an useful complement to judicial procedures by ensuring both parties an expeditious value recovering from unpaid loans in a timely and predictable manner.

[81] Based on Expert Group on ACE discussions, and stakeholder input received to the public consultation and in bilateral meetings.

- The AECE would strengthen the debtor's contractual commitment at lower cost and incentivise banks to grant lending to companies by enhancing predictability in the execution of the loan contractual terms.

Impacts on employees

Effective out-of-court procedures for collateral enforcement will have a positive influence upon employment and entrepreneurship because they would facilitate access to finance for companies and entrepreneurs. As already explained in other sections, banks will be incentivised to give more loans if they could recover more value and in a swifter manner in case of default by the company or entrepreneur.

In certain cases, there could be a possible indirect impact on employees. This could be the case if the collateral which is enforced through AECE is essential for continuation of operations (e.g. main machinery or premises of the company). In such a case the overall situation of the company or the entrepreneur could be impacted to an extent which could lead to making it impossible for that company/entrepreneur to continue performing its activities. This could lead to the company/entrepreneur having to lay off employees. However, in such a case the company/entrepreneur could ask the court to grant a temporary stay and open a preventive restructuring or insolvency proceeding. An important safeguard for the company/entrepreneur is the right to file for the opening of a preventive restructuring proceeding even before the creditor could trigger the AECE. The ability of a company or entrepreneur to request the judicial court to open a restructuring or insolvency procedure at any time will ensure that the employees of the company/entrepreneur concerned will benefit from all the rights and protections which are available to workers under such procedures. The retained option will not impact any of the workers' rights under the existing legislation.

In conclusion, the use of the out-of-court procedure could accelerate the moment employees would be laid off as compared to a judicial enforcement or an insolvency procedure, even as compared to the most effective insolvency regimes. Available preventive procedures should provide safeguards to ensure that viable companies can find a debt resolution that would allow for a continuation of the company.

12.3 Impacts on fundamental rights

When assessing the impact of the envisaged initiative to enhance the effectiveness of value recovery by secured creditors, the valuation pays particular attention to fundamental rights in order to ensure that the proposed options fully respect the rights and principles set out in the European Union Charter of Fundamental Rights, in particular those in Article 17 (right to property), Article 16 (freedom to conduct a business), Article 47 (2) (right to a fair trial), and Article 7 (respect for private and a family life).

Right to property : In situations where, following the use of the AECE, the borrower may lose the premises where its business operates, the fundamental right to property comes into question. Article 17 of the European Charter of Fundamental Rights (ECFR)[82] enshrines a right to property, as being the right to peaceful enjoyment of one's property or possessions, not to be deprived of possessions unless certain conditions are met and to have the use of property controlled only in accordance with the general interest. The concept of property, or "possessions", is very broadly interpreted. It covers a range of economic interests, including 'movable or immovable property, tangible or intangible interests, the economic interests connected with the running of a business, the right to exercise a profession, and a legal claim. The right of the borrower to property and the right of unsecured creditors to a legal claim are therefore both protected under this provision. The right to property is not absolute, but must be applied on balance with other values. Interferences with the enjoyment of property can be justified by a legitimate objective, provided that the measures are proportionate.

Several elements have been considered from the perspective of compliance with the right to property:

- The main residence of the borrower has been excluded from the scope of the initiative;
- A set of principles will be established to ensure that the out-of-court enforcement procedure maximises collateral value upon enforcement;
- Rules are foreseen to prevent an abusive use of AECE by secured creditors. In practice, such measures should avoid that a secured creditor enforces real estate to satisfy a minor claim.

Right to an effective remedy and to request the opening of a preventive restructuring or insolvency procedure: Article 47 (2) of the ECFR enshrines the right to an effective remedy and to fair trial for anyone engaged in a civil law dispute[83]. In the AECE, several measures have been considered from the perspective of compliance with the right to an effective remedy and safeguards were designed to address potential concerns: (i) the principle that the borrower and the secured creditor may initiate a judicial proceeding at any time during the use of AECE to enable the borrower to challenge at any time the use of the AECE by the secured creditor; and (ii) the principle is that the AECE shall be suspended once a preventive restructuring procedure is triggered and a creditor stay is granted. This principle should ensure that the borrower may at any time request a judicial court to open a preventive restructuring or insolvency procedure to preserve the borrower's right to conduct a business.

12.4 Environmental and other impacts

No major environmental or other impacts are expected for this proposal.

12.5 REFIT (simplification and improved efficiency)

As this impact assessment pertains to a new initiative at the EU level, a REFIT analysis is not applicable.

[82] See also Article 1 of Protocol 1 to the European Convention on Human Rights (ECHR).
[83] See also Article 13 and 6 of the ECHR.

It is worth mentioning in this context, however, that this initiative aims at improving the efficiency of collateral enforcement through other means than formal courts proceedings. This should in the medium term lead to freeing up court capacity, as many more cases will be dealt extrajudicially, and lead to lower costs for Member States and the taxpayer.

8.6. **Estimated impacts of a possible legislative initiative (option 2) on Member States' national legal frameworks**

MS	**Is an out-of-court enforcement of collateral possible?**	**Does the system cover immovable property (real estate)?**	**Does the system cover movable property (machinery, tools)?**	**How far MS will have to reform existing schemes?** (low to high intensity level)[84]
AT	YES	YES	YES	low
BE	YES, but limited scope	NO	YES	medium
BG	YES, but limited scope	NO	YES	medium
HR	YES, but limited scope	NO	YES	medium
CY	YES	YES	YES	low
CZ	YES	YES	YES	low
DE	YES	YES, but minimum court involvement needed	YES	low
DK	NO	-	-	high

[84] These are rough estimates. The need and extent of national reforms which would be needed in Member States will depend on the precise features of a possible EU framework and the features of existing mechanisms for extrajudicial enforcement. The preferred option refers to a minimum; harmonisation directive which would build on national systems which work well.

EE	YES	YES, but minimum court involvement needed	-	medium
EL	NO	-	-	high
FI	YES, but limited scope	NO	YES	medium
FR	YES	YES	YES	low
HU	YES, but limited scope	NO	YES but unclear how broad the scope is	medium
IE	YES	YES	YES	low
IT	YES	YES	YES	low
LV	YES, but limited scope	NO	YES	medium
LT	YES	YES	YES	low
LU	YES, but minimum court involvement needed	YES, but minimum court involvement needed	YES, but minimum court involvement needed	low
MT	NO	-	-	high
NL	YES	YES	YES	low
PL	YES, but limited scope	NO	YES	medium
PT	YES, but limited scope	NO	YES	medium
RO	YES, but limited scope	NO	YES	medium

SK	YES	YES	YES	low
SI	YES	YES (for loans originated after 20lowmedium)	YES	low
ES	YES	YES	YES	low
SE	YES, but limited scope	NO	YES	medium
UK	YES	YES	YES	low
Total	**25 YES / 3 NO**	**15 YES / 13 NO**	**24 YES / 4 NO**	-

13 How will actual impacts be monitored and evaluated?

The proposal is expected to follow normal implementation procedures. Ex-post evaluation of all new legislative measures is a top priority for the Commission. The Commission shall establish a programme for monitoring the outputs, results and impacts of this initiative one year after the legal instrument becomes effective. The monitoring programme shall set out the means by which the data and other necessary evidence will be collected. An evaluation is envisaged 5 years after the implementation of the measure. The objective of the evaluation will be to assess, among other things, how effective and efficient it has been in terms of achieving the objectives presented in this impact assessment and to decide whether new measures or amendments are needed.

In terms of indicators and sources that could be used during the evaluation the following monitoring indicators:

- Number of secured loans which are enforced through out-of-court procedures;
- Timeframes and value of recovery rates in case of secured lending;
- Evolution of secured NPLs to business;
- Evolution of lending to corporates and decrease of cost of lending including cross-border.

The 2016 Commission proposal on preventive restructuring and second chance[85] includes an obligation for Member States to provide annual statistical data on inter alia: (i) the number of

[85] SWD(2016) 357 final – Commission Impact Assessment

preventive restructuring procedures opened by enterprises in difficulty, (iii) the average length of proceedings, including particular procedural phases (e.g. before courts, out-of-court), and (iii) recovery rates in different types of procedures.

Given the limited availability of data on out-of-court mechanisms, national competent authorities which supervise banks would be required to collect information on the number of secured loans which are enforced through the AECE and the timeframes for such enforcement. The proposal will asks Member States to provide annual statistical data on these matters one year after the legal instrument becomes effective. While the Commission will be in charge of monitoring the implementation of the directive according to EU law, the other indicators will be collected through the help of national competent authorities.

Annex 1 – Procedural information

I. Lead DG, DeCIDE planning /CWP references

This Impact Assessment Report was prepared by Directorate C "Financial markets" of the Directorate-General for Financial Stability, Financial Services and Capital Markets Union" (DG FISMA).

The Decide Planning reference of the "*Accelerated Loan security - Protection of secured creditors from business borrowers' default*" is PLAN/2017/1406, published 7 July 2017.

Strengthening the position of secured creditors is part of the broader strategy of the Commission to deal with NPLs. This possible legislative initiative has been announced in the Mid-term review of the CMU Action Plan (8.06.2017)[86] and in the Commission Communication on the Banking Union (11.10.207)[87].

II. Organisation and timing

Several services of the Commission with an interest in the assessment of the initiative have been associated in the development of this analysis.

Three Inter-Service Steering Group (ISSG) meetings, consisting of representatives from various Directorates-General of the Commission, were held in 2017.

The first meeting took place in September 2017 has been attended by DG ECFIN, GROW, JUST, TRADE and the Secretariat General (SG).

The second meeting was held on 2 October 2017. Representatives from DG ECFIN, JUST, GROW and the Secretariat General (SG) were present.

The third meeting was held on 4 December 2017 2017 has been attended by DG ECFIN, and the Secretariat General (SG). This was the last meeting of the ISSG before the submission to the Regulatory Scrutiny Board on 6 December 2017. DG FISMA has had several bilateral exchanges with DG JUST in anticipation of the 4 December meeting in order to ensure that the impact assessment takes into account DG JUST's observations.

The meetings were chaired by SG.

DG FISMA has updated the Impact Assessment by taking into account the comments made by SG, ECFIN, JUST and GROW. In particular, the following changes were made:

- DG FISMA has integrated in the impact assessment the comments received from DG JUST as regards the ways by which it would be ensured that an initiative on out-of-court enforcement of collateral would be fully consistent and complementary to the 2016 Commission proposal on preventative restructuring frameworks.

[86] CMU MTR Communication - https://ec.europa.eu/info/sites/info/files/communication-cmu-mid-term-review-june2017_en.pdf

[87] Banking Union Communication - http://ec.europa.eu/finance/docs/law/171011-communication-banking-union_en.pdf

- DG FISMA has addressed the comments made by SG and DG ECFIN concerning the interaction between this initiative and the other Commission work strands which aim to address the NPL problem. Such comments have been addressed in the introductory section and the section on the impacts of this initiative- on a stand-alone basis and as part of the broader NPL package.
- DG FISMA has integrated in the impact assessment the comments received from DG JUST as regards consumer protection aspects, to ensure that consumers are excluded from the scope of this initiative.
- DG FISMA has addressed the comments made by DG GROW as regards the need to present the possible impact of a framework on out-of-court collateral enforcement on SMEs by indicating, in respect to the three options analyses, the estimated impact on SMEs.

III. Exceptions to the better regulation guidelines

No exception from the Better Regulation Guidelines has been identified by DG FISMA.

IV. Consultation of the Regulatory Scrutiny Board (RSB)

The Impact Assessment report was examined by the Regulatory Scrutiny Board on 10 January, 2018. The Board gave a positive opinion.

V. Evidence, sources and quality

The impact assessment has been carried out with the comprehensive qualitative and quantitative evidence from:

- **Mapping of existing legal framework** of Member States on out-of-court collateral enforcement. This has been carried out on the basis of the responses sent by the Ministries of Justice of Member States to a questionnaire sent by the Commission services on 22 September 2017. 13 Member States (AT, BE, CZ, DE, DK, ES, FI, FR, IT, LV, PL, SK, UK) have responded to the questionnaire. The mapping has also been informed by the input provided by some experts, member of the DG JUST expert group;

- Public consultation carried out by the Commission between July and October 2017;

- Other sources used: Uncitral, EBRD, SSM report, FCS NPL taskforce report, K&L Gates LLP European Insolvency and Enforcement Country Guide, Linklaters studies, Deloitte Legal study, and other studies and papers referred to in the Section on "References".

Annex 2 – Stakeholder consultation

LIST OF MOST IMPORTANT CONSULTATIONS

The Commission has consulted stakeholders in many different ways. A list of the most important consultations is provided below:

- **Public consultation** (July- October 2017): 60 contributions received

- **Dedicated meeting with Member States:**
  (i) meeting with MS representatives of Ministry of Finance at the Council Financial Services Committee (FSC – task force of NPLs) (24 May 2017- and 6 December);
  (ii) Meeting with MS representatives of Ministries of Finance and Justice (20 November 2017)

- **Legal expert group meetings** (on 19 September 2017 and 25 October 2017,), i.e. DG JUST expert group on restructuring and insolvency law that was created end-November 2015[88].

- **Bilateral Meeting with stakeholders** (on-going) - i.e. bank associations, industry, SME representatives etc.

- **Banking expert group meeting on 14 December**

Public consultation

The public consultation asked for feedback on the creation of a new security right labelled "accelerated loan security" (ALS). The answers provided can be structured around the following main themes:

- benefits and risks of out-of-court enforcement mechanisms currently existing
- Benefits, risks and possible features and scope of ALS
- Consistency of ALS with national legal frameworks (preventive restructuring framework and the insolvency law, public and private law rules and principles and collateral legal framework)

The stakeholders can be clustered in the following groups:

- banking industry
- investors and loan servicing companies
- government and public authorities
- law firms
- consumer associations, NGOs and private individuals

[88] Detailed list of experts could be found on the Register of Commission expert groups (http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetail&groupID=3362)

The summary and analysis of the responses will then be grouped around the three main themes and the five stakeholders groups identified above.

Existence of out-of-court enforcement mechanisms in MS, their benefits and risks

Banking industry

The banking industry sees the following main benefits/risks for out-of-court enforcement mechanisms:

- Out-of-court enforcement mechanisms (where they exist) are not similar across jurisdictions. In general, these provisions are more time efficient and less costly, however, in some jurisdictions, the debtor has means to defend himself, including via court protection. The challenges vary between jurisdictions, for example, the need for cooperation of the debtor (which is problematic), to frequent amendments to the law, valuation issues, etc.
- Court auctions normally result in heavy discounts from market level and the avoidance of the court involvement in the disposal of the collateral ensures that the bank finds the appropriate market place for a given collateral increasing the chances of recoveries at market value. This helps to avoid the accumulation of non-performing loans through better recoveries in shorter periods of time (especially in jurisdictions with suboptimal in-court enforcement procedures)
- Less risk and easier access to quick enforcement for lenders should lead to lower interest rates and better terms overall for borrowers
- The threat of a possible collateral enforcement can in itself be persuasive. Therefore banks do not automatically wish to enforce the collateral, they wish to keep the freedom of choosing to enforce the collateral or not.
- The recent reform in Italy (Patto Marciano) is expected to reduce the timing vis-à-vis a judicial enforcement proceeding or the foreclosure of the guaranteed assets although so far the measure has not been particularly well accepted by the market given lack of incentives for borrowers to accept the new clause in the loan agreement and the condition for the execution (the non-payment of 9 instalments is considered a very long period)

Investors and loan servicing companies

- The ability to rely upon out-of-court enforcement varies from relatively sophisticated out-of-court procedures in England to court driven enforcement in a number of other European member states. There are obvious costs and time efficiencies that are derived from an out-of-court process which can lead to better recoveries. It is worth noting that banks in Europe also benefit from the European Financial Collateral Directive, which allows financial collateral arrangements to be enforced by way of appropriation and no court involvement. The Directive has been implemented in different ways and is dependent upon an arrangement falling within a specified category. Generally speaking the Directive has been welcomed by lenders who have benefitted from its application, and have as a consequence avoided the need to resort to the courts. Of course part of its effectiveness relied upon the fact that it switches off the debtor protections derived from insolvency laws.
- In Spain, there is a possibility to enforce mortgages out-of-court (always providing that it was agreed in advance by lender and borrower). This type of enforcement is much faster but could be more expensive than a judicial one. Nowadays, debtors are entitled to as same protection as in a judicial enforcement (depending on features of

the specific debtor, and type of real estate), which somehow impairs the hypothetical advantages of this form of enforcement. This enforcement is out-of-court, but requests the intervention of a Notary Public, and debtor is always entitled to the standard legal protection, so it is not considered that there are risks neither challenges different than in a judicial proceeding.

- The Belgian legislator has adopted a new framework for movable asset security, pursuant to which such out-of-court enforcement will be generally possible for all security over movable assets. The entry into force of such framework has been postponed a number of times and is currently foreseen for 1 January 2018. This new feature is generally welcomed by market participants in Belgium. It is expected that this reform will reduce unnecessary transaction/enforcement costs. In general, lenders will be able to act more swiftly in an enforcement scenario. It should be noted, however, that any action taken by a secured lender in these circumstances will be subject to ex post judicial scrutiny. It is expected that enforcement provisions in security documents will become more detailed to provide the lender with clear guidelines for enforcement. Faster enforcement and resolution procedures will have a positive effect on resolving NPLs and helping banks to more efficiently remove them from their balance sheets
- Benefits could arise from both the use of the out-of-court instrument for avoiding foreclosures and from the standardization and certainty provided by an EU action

Government and public authorities

- Out-of-court proceedings allows for relatively quickly recovery of the loan which in turn increases the amount of recovery (in present value terms). EU framework should deliver some added value, since it will further harmonize enforcement procedures and set mutually recognized standards. It could contribute to deeper integration of the financial markets and facilitation of cross-border activities
- Improving the protection of secured creditors in instrumental in resolving and reducing non -performing loans
- Some Member States have implemented banking and civil law legislative reforms to provide banks with contractual-based security rights which allows for an out-of-court repossession of collaterals. These protections are currently not available to banks in all Member States which from an economic point of view is pivotal for sound cross-border lending. The fragmented legal framework and the inefficiency of the judicial system between member states in the field of collateral enforcement represents vulnerability for bank stability (through the possibility of systemic crisis) having a negative impact on the capacity of financial institution to provide lending. Therefore, a greater convergence in EU secured loan enforcement systems could benefit enterprises by facilitating credit
- Out-of-court mechanisms have a positive (although somewhat limited) impact on NPLs as they would improve marginally the quality of the collateral (as it will be less impacted by a decrease in value due to long procedures) and its liquidity.

Law firms:

- An efficient, out-of-court enforcement process is essential for all security rights to ensure that they are effective and facilitate resolution of debts
- In theory, realisation of collateral out-of-court by using an accelerated enforcement device, promises a quick exit. However, even where such an option exists, lenders in

some jurisdictions may be reluctant to use it. One reason for this is that lenders view court-enforcement as providing a layer of protection from liability vis-à-vis those borrowers who claim the proceeds should have been higher. In order to avoid such challenges, lenders are often keen to agree upon co-operative exits with borrowers. Professional third party loan servicers may be more willing to use an out-of-court option in jurisdictions where these concerns arise as they have less fear of reputational damage

- Introducing an harmonized enforcement process across MS would become increasingly familiar to non-EU investors thereby reducing the barriers to entry into new EU jurisdiction for such investors
- Provisions about out-of-court collateral enforcement mechanisms in UK provide banks with certainty in respect of process and timing to enforce security. Given that the processes are very familiar, investors are able to price the underlying collateral as they have visibility on the process and hence there is more liquidity in the market
- An efficient, out-of-court enforcement process is essential for all security rights to ensure that they are effective and facilitate resolution of debts

Consumer associations, NGOs and private individuals

- The Commission services have not received any feedback on this from consumer associations, NGOs and private individuals.

Benefits, risks, possible features and scope of ALS

Banking industry

The banking industry sees the following main benefits with the creation of ALS:

- ALS could lead to increased access to capital and would support the stability of the financial sector and through an harmonized approach would also encourage further cross-border lending
- the benefits of such instrument are considerable if it remains valid/enforceable in insolvency / pre-insolvency processes (although it is recognized that such an advantage for secured creditors cannot be integrated into national insolvency regimes without significant disruptions)
- benefits can be further enhanced if loans backed by ALS were to be granted preferential prudential treatment (lower capital requirements)
- Borrowers would be very inclined to accept this security if the costs are adjusted. An immovable property as security might be very expensive nowadays in certain jurisdictions (costs that are born by the debtor). Therefore, if this security entails lower costs, it would be very much welcomed by the debtors when offered by the lenders.
- The benefits are potentially huge: no foreclosure costs, no auction value depreciation (higher sale price), shorter liquidation timing, improvement in debtors' discipline, possibility (upon negotiation) of full debt discharge for the borrower in case of sale at price lower than debt, etc. However, no bank has ever made use of this possibility in Italy due to the high risks of consequent claims and economic loss when asset repossessed are not sold in time / at the desired price. The main risk for litigation is the relationship with insolvency and bankruptcy when many creditors claim rights on the asset.

The main risks seen by the banking industry:

- Because of inherent risks associated with the assets (especially mortgaged real estate), it would be preferable to be granted authority to sell instead of becoming the owner of the assets. With repossession the bank would have to consolidate newly acquired assets on their balance sheets to the detriment of e.g. capital allocation requirements.
- private sale or an auction with proceeds going directly to the lender were mentioned as alternative methods to satisfy the lender while keeping the assets off the balance sheet. One specific banking association however sees no major obstacles or risks in banks becoming the owner of the collateral (from a neither balance sheet nor operational perspective).
- Another mentioned risk is that the entitlement to enforce is contested by the collateral pledgor or mortgagor (the pledgor or mortgagor can for example request a court injunction forbidding the pledgee or mortgagee to enforce on the basis that the pledgee or mortgagee has failed to exercise reasonable forbearance). It' argued that in certain MS one of the main obstacles to efficient enforcement of collateral are the privileged granted to the debtor (as the weakest party) which tend to weaken negotiations for its future possibility of opposition or revocation.

On the features and the scope:

- In general, the banking industry is against the debtor's full discharge as it could encourage borrowers to act irresponsibly and increase speculative behaviours especially when the recovered value from the sale of assets is lower than the value of the outstanding loan. The increase in moral hazard might drive up the price of credit to compensate for the risk. It is argued that the lender's position would be even worse than without security (as long as part of the debt would be erased automatically) and by allowing the borrower to repay the loan by transferring the ownership of the assets to the banks would change the lending philosophy from lending based on credit risk (i.e. credit worthiness of the debtor) to asset financing (as the risk would now depend mainly on the value of the assets). Moreover the increase of asset/collateral would only positively impact the debtor. However one association at the same time argued that one positive aspect of discharging debtors is that it could facilitate cooperation between the parties which will lead to faster NPL resolution and potentially higher recoveries (in net present value) which in turn should reflect lower fees and interest rates for new loans.
- General agreement on the scope i.e. excluding consumers from such a mechanism although one association points out that Mortgage Credit Directive provides that "Member states shall not prevent the parties to a credit agreement from expressly agreeing that return or transfer to the creditor of the security or proceeds from the sale of the security is sufficient to repay the credit". Another respondent, while acknowledging the sensitive nature of dealing with retail NPL, points out to the substantial stock in retail NPL.
- The transfer of ownership in case of default should be done in a commercial manner (with prior valuation, with proper publicity in advance) in order to derive the best value. With that regards, it is also argued that the value of the collateral would necessarily have to be established after the debtor’s default as, for example, the moment in which the asset’s ownership is transferred to the bank. This is the only way in which risks of objection of such transfer can be limited (e.g. risks of inconsistency between the value determined by the expert and the amounts lent, probably issued on

the basis of values that were not consistent with the “minimum” value established at the time of the granting of the loan).

- Instead of the transferring the property, the borrower should be obliged to grant the bank (or any other broker, estate agent, real estate company, etc.) power of attorney for the sale of the asset on the market at a price estimated by independent third party expert. Only when and if the bank succeeds in selling the asset, the bank should be obliged to return the excess of the sale proceeds or reduce the outstanding debt if sale price was lower than debt. In this way all taxes and liabilities will be based on a real sale price (and not on an estimated value).
- General agreement on the collateral scope i.e. excluding borrower's main residence (with a suggestion from one respondent to exclude the main residence identified at the time the credit was granted but not to exclude residential assets that fall within the categories of villa, castle, luxury property and other comparable assets). Other respondent would only exclude the primary residence for small entrepreneurs or agricultural sector works.
- One respondent argued that ALS would not be possible without an efficient judicial system with the need of judicial controls and the possibility for legal protection of both the debtors and the guarantors.

Investors and loan servicing companies

- Important that the ALS would be transferable to the investors otherwise it would create an obstacle for the secondary market
- ALS could help with the avoidance of future accumulation on NPLs especially if other relevant changes in law makes it enforceable and practicable (e.g. the fact that all debtors are entitled to the same legal protection both in judicial and extra-judicial proceedings might prejudice this type of enforcement)
- As for the debtor safeguards it was pointed out that a balance is needed between a minor breach of the loan agreement repayment in view of its total length, the trigger events for enforcing such security shall be very well and precisely established, including giving to the debtor second chance for compliance with the payment schedule
- Ok on the scope (excluding consumers) recognizing the need to special protection for the weakest party
- ALS may not get much traction because contrary to the European Financial Collateral Directive it is not foreseen to switch off the debtor protections derived from insolvency laws
- It should make sure that ALS is not abused or used in a manner that results in unfair prejudice to the rights of certain market participants (e.g. permitting the holder of ALS to enforce its security at a time when the company may be in trouble while exposing all other creditors to clawbacks or other asset transfer restrictions at that time may not result in the best result for the company or the creditors). However, a properly structured ALS might be very helpful in allowing banks to resolve NPLs and remove them from their balance sheets.
- The full discharge of the debtor may discourage banks as the risk of a reduction in the price of the collateral is born by the bank while an increase only benefits the debtor.
- One particular investor association had views similar to those expressed by most banking associations with regards to the scope, the need to provide the banks the power of attorney for the sale of the asset instead of transferring the property, instead of discharge from further repayment obligations debtors should be incentivized to use

ALS as it is cheaper compared to the security rights in terms of tax and registration requirements

Government and public authorities

- Doubts about the fact the instrument can significantly accelerate the general process in those MS where the foreclosure procedures carried out by courts are already being handled in a short period of time. The protection mechanisms for the debtor (e.g. obtaining an up to date expert valuation of asset prices) would probably slow down the process even further.
- Uncertainties associated with the acquisition and realization of the collateral are difficult to avoid and will represent burdens to the realization process. In particular, the process of realizing an ALS cannot escape judicial review of the involved matters and hence this raises doubts as to whether problems in effectiveness and efficiency of judicial procedures can be solved by allowing for an out-of-court enforcement of collateral. One MS calls for rather strengthened (quick, transparent, and legally certain) judicial procedure.
- It is doubtful that secured creditors, particularly credit institutions in Member States with efficient enforcement and insolvency systems, have an interest in acquiring the ownership of the collateral. Such interest could only exist if there is no other viable possibility of utilizing the collateral because of the lack of efficient enforcement systems. In the case of real estate, in particular, a large number of burdens are associated with ownership which will entail expenses, costs and risks
- Generally ok with the scope (especially the exclusion made on social equity grounds) but the tight applicable framework and possible exceptions raise doubts about whether such an instrument would be of great relevance in practice (sometimes the privately used property might be the only asset owned by SME that would qualify as collateral). Also given that the regulation regarding transfer and enforcement of these two forms of collateral differ considerably, it is suggested to have two sets of rules for real estate and movables. However one MS questions how the limitation of the scope of application to commercial transactions is to be ensured legally, especially as the type of use of an encumbered estate may change in the course of time; also it raises doubts about the restriction of the scope of application with regard to the initial residence of the debtor and his relatives hence this is thought to entail a considerable risk of abuse and weakens the instrument.
- The need of appropriate balance between the legitimate interests of secured creditors in having their rights enforced without delay and the protection of the rights of debtors e.g. need to have an fair evaluation carried out by a third party at the time of transfer (not ex ante) in order to avoid the tension between the debtor and the creditor.
- ALS gives priority in enforcing secured loans through selling collateral and hence secured creditors could be less willing to participate in corporate restructuring proceedings adversely impacting the outcome of such proceedings and other creditors chances to recover their debts.
- Transferring the main assets to the bank would result in severe disruption of the normal business operations and deteriorates the ability of the firm to repay the remaining part of the loan (if the outstanding amount was higher than the value of the assets) as well as the ability to service other debts.
- Doubts about the full discharge for the debtor which calls into question the strengthening of the position of secured creditors as any subsequent decrease in value of the assets results in a unilateral burden to the creditor. One safeguard for debtors

suggested is to involve a third party responsible to oversight the realisation process and assuring that the interests of both creditors and debtors are met.
- Important to clarify the impacts of ALS also on non-secured lending.

Law firms

- The best value is rarely attained by forcing the repossession of asset. Forced repossession leaves the bank with an asset which does not provide any productivity between repossession and sale. This, plus the urgency of sale, leads the bank to sell the repossessed asset below its real value. As a result, the part of the outstanding loan not covered by the sale of the asset remains high. The result of this is, for the bank, a higher LGD than it would have been with a more proper solution, and for the borrower a worsening economic situation. However, in some specific cases, quick repossession and immediate sale may ensure that the asset generates the best possible value. Only in the very specific case where an asset is already unused and when early repossession, with the guarantee of an early and efficient sale, is the best way to preserve its value, and therefore the economic benefit for both parties. As such, the key feature of repossession should concentrate on operational / economic factors. In particular, repossession should be prohibited whenever these conditions are met : - mediation is possible;- the asset is in use, resale is not immediately available, and the absence of the asset would worsen the situation of the borrower with no advantage for the lender; - the market for resale is insufficient to ensure that the repossession will be more profitable that a more operational solution
- The new out-of-court enforcement option should be made available to all lenders (banks and non-bank)
- The ALS would provide further optionality to banks who wish to enforce loans to avoid accumulation of NPLs and may improve capital flows to the country as lenders would have pre-determined exit routes. However, the appetite to enforce such an instrument will clearly be lender-specific and therefore in itself, may not avoid the future accumulation of NPLs.

Consumer associations, NGOs and private individuals

- Ok with limiting the scope of application (restriction to corporate and excluding primary residency) on social equity considerations with a suggestion to possibly adopt specific rules under which ALS can be applied for individual borrowers if the positive effects in terms of increasing access to finance for businesses are realised in practice;
- Ranking of creditors should not be tampered with;
- With regards to the possible features for the ALS it is suggested: i) compulsory setting of a (minimum) value of the assets in advance by an independent expert, following the criteria that could be set out in the security right or in the loan contract and ii) there should be a mandatory duty to pay back the difference to the borrower once the asset is sold whenever the evaluation of the asset leads to a value higher than the debt amount
- The mechanism trigger should be subordinated to a request by the bank to the borrowers for a revised business plan and possible restructuring – only in case of a failure to comply with this request the bank should be able to trigger the mechanism.

Consistency of ALS with national legal frameworks (preventive restructuring framework and the insolvency law, public and private law rules and principles and collateral legal framework)

Banking sector

- The fact that the ALS would only be enforceable as long as the debtor is not in financial distress would weaken the value of security and would discourage banks holding such security from supporting restructuring efforts for a debtor's potentially viable business. The ALS should be enforceable even in those occasions. However one banking association agrees that the use of this instrument should be limited if there is a stay but when the stay is lifted banks should be able to trigger the ALS. Other stakeholder mentions that a stay of the enforcement shall only be granted if the mortgaged asset is necessary for the business of the insolvency debtor.
- The ALS as a contractual right would have to be tailored to each MS in order to accommodate existing legal frameworks of private law which are highly diversified within the EU
- The most important element to be taken into consideration is the general principle of the "*par condicio creditorum*", represented by the "stay" of individual enforcement actions and, consequently, the exclusive satisfaction of all the creditors with the insolvency proceeding's assets. Moreover, in order to benefit from the relevant bankruptcy provisions regarding mortgages and pledges, the accelerated loan security should be expressly equalized to the other collateral security
- Rules should be provided in terms of relationship with the other collaterals provided by the MS laws for example the collateral at inception should not impose restrictions on the use of other forms of collaterals that are currently available
- For one banking association, the existence of an instrument which could be enforced rapidly appears to run counter the proposed widespread implementation in insolvency or pre-insolvency of a "stay of execution" to enable viable but distressed companies to find a solution to preserve value for all stakeholders. If a corporate borrower is still in activity it should be ensured that the collateral is not enforced if the assets are vital to the borrower's operations.

Investors and loan servicing companies

- To be consistent with local private law, the instrument shall be preferably regulated by the Civil Code as a new security instrument to be established by an agreement between some categories of creditors and debtors. As regards public law, an accelerated loan security instrument concerning the immovable assets should be registered in the Land Registry. These creditors should have the right to register this security instrument concerning the movable assets in the notaries register

Government and public authorities

- No specific rules for insolvency should be introduced. The accelerated loan security instrument should rather fall under existing national law regulating national insolvency or EU law with respect to the treatment of collateral in case of insolvency or pre-insolvency. It is important to have the possibility to suspend utilization to provide continuation of business. Special rules for appeal or similar claims should not be introduced.
- It is important that the preconditions for effectively grounding security rights remain within the framework of national law (as is the case, for instance, with the registration

in the land register for real estate). Legislation at EU-level should be limited to define the circumstances under which an accelerated loan security instrument can be applied, like the scope of application and the explicit approval of the security provider. Additionally, EU legislation should determine which protective measures should apply in case of utilization or sale.

- The subject matter of securing loans and means available to secure loans is closely linked to various areas of the Member States' national legal systems and is based on them, in particular on the substantive law of property and on enforcement law. These legal areas differ in the Member States according to their respective legal traditions and economic structures. Against this background, the creation of an independent European security instrument in addition to the existing security interests under national law could be seen as a sensible approach only if it could be integrated into the national legal orders.
- ALS calls into question the effectiveness and efficiency of insolvency law and, in particular, the feasibility of continuing and restructuring distressed companies. Both require the option of maintaining a business as a going concern despite of the opening of insolvency proceedings. Only then can the going concern value be fully preserved and realized. It follows that insolvency law must impose some restrictions on the utilization of the collateral. A free, unrestricted right to dispose, or otherwise realize the value of the collateral is thus not compatible with the aforementioned demands. It would inevitably result in an erosion of the company as a functioning economic entity, preventing recovery options and precluding the realization of the company's full value and also excluding restructuring opportunities. Although the nature of participation of the secured creditors in insolvency proceedings may differ in the Member States, it follows from these fundamental considerations that secured creditors' rights to foreclose security interests must be subject to some insolvency law restrictions, which do not allow for an extra-judicial, unrestricted right to dispose of, or otherwise realize the value of, the collateral.

Law firms

- To encourage the use of an accelerated enforcement device, legal systems in Member States would need to be harmonised with a view to cross-border collateralisations and accepting that some protection currently available to borrowers would need to be relinquished to enable accelerated enforcement to be used (e.g. with commercial real estate or share pledges).

Consumer associations, NGOs and private individuals

- It is of essence that the preventive restructuring framework proposed by the Commission in November 2016 is a directive as soon as possible and implemented in those jurisdictions which do not have such a tool also as soon as possible. It is of essence that such proposal is implemented in the current terms in relation to the stay or even with an automatic stay. This is the only real protection for non -beneficiaries creditors of the "accelerated loan security" and the debtor with whom they are negotiating. Any abuse of this protection can be sufficiently avoided with article 6, paragraph 8 of the Directive proposal. In these circumstances article 6, paragraph 9 will not apply when a stay affects an accelerated loan security enforcement.

Meetings with member states

Financial Services Committee meeting on 24.05.2017

The concept of an ALS was presented at that meeting. The members of the Financial Services Committee (FSC) have been overall supportive to the main elements of an ALS, as described in the discussion non-paper.

IT explained very well the benefits of introducing the accelerated loan security, such as:

1. Improving the quality of collateral
2. Decreasing the cost of credit
3. Making the credit less risky and so more accessible
4. Lowering the accumulation of NPLs in banks portfolio/balance-sheet

Any harmonisation of such a measure (inspired by IT patto marciano and non-possessory pledge) would promote integration across MS helping the cross-border dimension.

ECB was very supportive and suggested also to look at the best practices already existing in some MS.

FR, DE, PT, BE and AT having similar instruments already in place (AT and BE only for movable asset) showed support.

FI, ES, BG, IE, LV, DK while agreeing with the general idea of the accelerated loan security, expressed some concerns about the consistency of this instrument with their national private law (e.g. property law, credit rules), judicial rules (enforcement proceeding) and public law (registration rules).

In general, the main requests of clarification of MS (that expressed their views) were about:

- Out-of-court mechanism
- Interaction with pre-insolvency regime (as per COM last proposal)
- Interaction with national insolvency law (impact on ranking of creditors and insolvency proceeding)
- General features of the accelerated loan security (scope, assets, definition of default, avoidance actions) and "option nature" of the regime (i.e. contractual choice of the parties).

Meeting with Member States on 20.11.2017

On 20 November, FISMA and JUST Commission services had a meeting with Member States' Finance and Justice representatives on Accelerated Extrajudicial Collateral Enforcement. All MS except for LV, SI and the UK were present, both Finance and Justice departments. The ECB and the EBA were also presented.

The purpose of the meeting was to present the Commission's work on the AECE and to exchange views with the Member States on this initiative, the interaction and possible interference with Member States' private and public laws, including insolvency, and with the

2016 proposal on preventive restructuring, as well as to explore the single market potential of this work.

The Commission presented the broader context of the NPL work including the Council Action Plan on tackling NPLs, the CMU MTR commitment and the Banking Union Communication and indicated that a package of measures is foreseen for Q1 2018. The key features of a potential EU framework were also presented. Member States were invited to comment on the proposed approach.

Member States seem to be divided between those that see merit in an EU framework on the AECE and those that expressed doubts about the value-added of a possible legislative initiative.

- Those that were in favour would support a principle-based framework which would leave sufficient flexibility to MS to implement the EU requirements in a way to make them fit into national private and public laws: (ES, MT, IE, PT, and SK).
- Some Member States were against a binding EU framework on out-of-court enforcement procedures: NL, AT, DE, FI and SE. Those MS would prefer a recommendation arguing that such an instrument would provide for a targeted approach depending on MS' systems.
- FR has not indicated a clear view, while expressing support for the objective of addressing the NPL issue. FR called for further discussions in an expert group.

A positive take from the meeting is that except for PL, the other MS do not see any big risk of interference with the 2016 Commission proposal on preventive restructuring frameworks (given the envisaged rule that AECE will be suspended when a stay is declared in restructuring). Very few expressed concerns about the AECE's possible negative impact on the viability of a company in case the business would be deprived of its main assets. However, MS seemed reassured by the envisaged principle that a company in default would have the right to challenge the use of AECE or to ask for the opening of a preventive restructuring procedure at any point in time.

As regards the scope of the initiative, MS agree with the exclusion of consumers and the main residence of a corporate borrower (except for SK). However, a number of MS called for extending the scope to other secured creditors such as suppliers, so that banks would not be the only entities that benefit from the AECE (FR, DE, BE, CZ). Those MS do not think the envisaged solution to allow other types of entities to benefit from AECE only when a loan equipped with AECE is transferred to a third party (i.e. distressed fund) would be sufficient. They would like all secured creditors to benefit from AECE from the moment they give a loan to a business.
As regards the assets which could be used as collateral, several MS called for excluding immovable assets (real estate): IT, DE, FI, AT, PL, BE and SE. Those MS argue that enforcement of real estate interferes too much with civil and public laws (That despite proposed rule to leave discretion to MS as regards the detailed implementation of EU requirements).

Concerning the characteristic of the out-of-court enforcement procedure, many MS would like to have flexibility to decide upon the mechanism which should be used for AECE. That is because MS which already have out-of-court procedures have established various mechanism- some use public sale, other private sale, or appropriation of the assets, and some others have two of three of these procedures available and it is up to the secured creditor to decide which mechanism should be used.

Financial Services Committee meeting on 6 December 2017

The Commission services presented the state of play on the broader NPL package, including on the work strand on the out-of-court collateral enforcement. The Commission services explained that, based on exploratory work and stakeholder feedback, the best way forward appears to be to focus only on enhancing the effectiveness of the enforcement procedure, and not, as originally foreseen, on the establishment of a new security right together with a harmonised enforcement procedure. That is because establishment of a new security right would have a strong impact on national private and public laws (i.e. impact on civil, public, insolvency laws and creditor hierarchy).

The FSC members were invite to express their views on whether a common out-of-court framework for collateral enforcement would strengthen the ability of banks to recover value from collateral, and thus contribute to enhancing financial stability by preventing the accumulation of NPLs on banks' balance sheets.

ES expressed support for this work strand and indicated that a number of aspects need to be clarified, including some very technical issues. For example, a farm which is the main residence of a business owner should be excluded from the scope of the initiative, given the envisaged exclusion of the primary residence of a business owner; consider registration aspects. ES considers that the "stay" rule in the 2016 Commission proposal on preventive restructuring is incompatible with out-of-court enforcement.
BE and ES called for extending the scope to other secured creditors than banks. FR supports the Commission's work and would welcome further technical discussions**.**

Expert group meetings

First expert group meeting on 19 September 2017

At the first meeting of DG JUST Expert Group the Commission services (FISMA and JUST) discussed with experts (judges, lawyers and academia) the policy objectives of enhancing financial stability, the overall approach of the Commission to tackling the NPL problem, and the work on enforcement of secured loans as a way to prevent the accumulation of NPLs on banks' balance sheets in the future. The meeting focused on analysing the possible features of an instrument which would ensure that all Member States make available an efficient out-of-court enforcement of secured loans. More precisely, the following topics have been discussed:

- A *tour de table* to analyse ALS's structure and different-comparable legal instruments existing at national level followed. As per the legal structure of the ALS, the main legal issues raised by the expert were:
- Legal qualification of the ALS - two approaches are possible (i) providing an out of-court enforcement to whatever security instruments Member States might have already in place (ii) build a new EU security right.

- Transfer of ownership (*i.e.* the "accelerated clause" under our first model) to the bank - it was not seen as a precondition to foreclose the unpaid loans (risk of interaction with property law, registration, third parties rights, constitutional law of some Member States).
- Implementation - In some countries (like FR) existing out-of-court enforcement instruments are not used (they are not attractive for banks).
- Out-of-court enforcement –the real need of an ALS-type instrument was questioned in Member States where the judicial system works well.

➢ The experts also raised some economic questions linked to the structure of the ALS such as the risk of over-protection of banks to the detriment of debtor's interests; the value-added of the ALS as an effective instrument to tackle NPLs given the significant changes that it would require to Member States' private and public laws; the fact that banks might prefer to sell the unpaid loans instead of enforcing; the fact that banks do not have an interest in becoming owners of machinery, tools etc. and have such assets on their balance sheets or incur liability for such assets (e.g. environmental liability).

The expert group suggested constructive inputs in designing the possible EU ALS structure, and suggested a careful assessment of the international private law dimension of the instrument (to allow cross- border enforcements) and the consistency of the ALS with national bankruptcy law and the recent COM proposal on restructuring and second chance (*e.g.* problem of ranking).

The Chair concluded the session recalling that the ALS instrument is one of the possible measures to solve NPLs of a more comprehensive framework that Commission services are developing and provided preliminary explanations on the different scope of the ALS and the Financial Collateral Directive (FCD).

The Chair stressed that the new mechanism envisaged should avoid interfering with the Commission 2016 proposal on preventive restructuring and second chance. The intention is to create a mechanism that would minimise impact on Member States' private and public law.

➢ ***Core features, scope, subject matter and main effect of the ALS***

The discussion showed that the "accelerated clause" of the ALS (*i.e.* the transfer of assets' ownership to the bank in case of debtor's default) should not be considered as a necessary precondition to enforce the loan. It would be better to open the ALS to 3 possibilities: (i) appropriation (ii) private sale and (iii) public sale. Different national law solutions (DE, IT, FR. PL) were discussed. 'Appropriation' should not be understood as the transfer of ownership rights (which would engender constitutional and practical problems), but rather of the right to dispose of the assets (DE, UK). There should be no automatic transfer to banks.

In order to create an incentive for banks in using the ALS and to encourage a secondary market to develop, the experts suggested not to limit the beneficiaries of the ALS clause to the originator banks and to allow the extension of the ALS for example "*to a third party designated by the bank*” (i.e. third financial institution).

The majority of the experts were in favour of shifting the ALS focus at the level of enforcement mechanism instead of creating a new EU security right (accordingly the name of the instrument might require some further adjustment). In this respect the problem of valuation of the assets and the interaction with national insolvency law were seen as critical points.

- ***Formalities and third parties effects:*** On the registration and formalities for the constitution of the ALS the Commission explained that it would be better not to interfere with Member States' private or public rules. The majority of the experts agreed that the topic should not to be addressed at EU level but not to be avoided in substance. They therefore underlined the importance of avoiding any impact of the ALS on third parties' rights.
- ***Debtor's default:*** The experts raised the importance of keeping a clear distinction between the definition of "debtor's default” and the “enforcement trigger” which should be related to payment default (and not any breach of covenant). While some experts considered the stand-still period as an essential tool to protect the debtor's interests, others questioned the need of the stand-still period given the judicial safeguards already in place in Member States. In this perspective, to make the ALS working, the enforcement trigger as well as any grace periods should be left to the ex-ante agreement of the parties, however a judicial suspension of the out-of-court enforcement should be possible to protect other interests (e.g. protecting the going concern value of the debtor).
- ***Valuation of the assets by a third party independent expert:*** The expert group saw merit in a pure contractual valuation of the assets instead of granting an evaluation proceeding by a third independent expert. The involvement of an expert, appointed by the Court, was seen from some experts as a possible deterrent for banks in using the ALS. It was also specified that the need of an valuation process would ultimately depend on the sale procedure: only in case of "appropriation" such valuation proceeding might be meaningful in order to protect the debtor (e.g. ensure that the asset is not sold at under-value). No matter the choice of the valuation proceeding, the assets should be sold at market value and banks should in any case return the eventual residual value of assets to the debtor.
- The experts were invited to provide in writing a short description of the extrajudicial enforcement mechanisms existing at national level.

Expert group meeting on 25 October 2017

At the second meeting of DG JUST Expert Group the Commission services have informed that based on the comments received from experts at the first meeting, the input received from stakeholders at the public consultation and the exploratory work carried out, it seemed that a more proportionate approach to achieve the policy objectives would be to focus on the enforcement of collateral, not on creating a new security right. That would also ensure a more proportionate approach and less interference with Member States' legal frameworks.

There was consensus among experts that new approach presented by Commission services seemed a better way to address the issue of lack of effective out-of-court enforcement procedures in Member States, and the lack of any such procedures in a few Member States.

The various possible key features of an AECE mechanism have been discussed:

- Nature and Scope of the mechanism: support for excluding consumers from the scope given reputational risks for banks.
- Discretion of contractual parties on the use of AECE: all experts agreed.

- Formalities/Publicity requirements and third parties effects: experts stressed that it is essential that third party be aware that a bank would be able to use the AECE and thus that the AECE should be subject to publicity requirements. Experts suggested that in order to minimise any impact on national registration rules for security rights, the principle should be the application of publicity requirements established under each Member State legal framework for the security right which is equipped with AECE. That is because AECE would not be a new security right which might require new, specific publicity, but a mechanism which follows an existing security right. This means that Member States would not have to put in place additional transparency requirements for the publication of AECE, other than those applicable for the publication of the security right which is equipped with AECE.
- Triggering the accelerating clause: experts disagreed with the proposed Commission approach that some of the conditions which need to be fulfilled so that a bank can use AECE should be set at EU level. Given that such matters are contractual matters, the conditions for triggering AECE should be left to the national level.
- Possible exceptions from the rule of triggering the AECE (mitigating factors): In order to trigger the AECE mechanism the default (i.e. triggering event) should be considered as "relevant". Experts were divided on the need and value added of some safeguards proposed by the Commission, i.e. :

  (i) maximum threshold above which should not possible to trigger the AECE and the parties should choose an in court enforcement

  (ii) allow the debtor to delay it payment if only a small part of the loan is outstanding – having a maximum of grace period-time before the AECE would be triggered (from 1 until 3 months).

- Procedure for the Accelerated Extrajudicial Collateral Enforcement: a majority of experts consider that private sale should be the recommended enforcement procedure. They stressed that the Commission should establish a minimum set of features which should ensure that private sale is a transparent process which leads to maximising the value recovered from collateral (need for sufficient publicity before the sale; suggestions to organise sales on line).
- Transfer of the AECE: Where a secured loan equipped with AECE is sold by the bank to a third party, that third party (which may be a distressed fund) would be able to use AECE in case of borrower's default (under the same conditions as the originating bank). All experts supported this approach.
- Consistency with preventive restructuring and second chance Commission proposal: Experts stressed that the AECE must remain consistent with and complementary to the Commission proposal on preventive restructuring and second chance. The specific features of a possible AECE must not affect the national rules and principles of pre-insolvency and insolvency proceedings. Experts agreed that in case of conflict the latter should prevail to the extent granted by national law. Therefore, an AECE would not prevent those provisions from having their desired effects, thereby maintaining the balance of debtors-creditors' interests and the order of priority of different creditors.

Bilateral meetings with stakeholders

The unit in charge of the file also organised and responded to requests for bilateral meetings with key stakeholders.

Meeting with business organisations on 23.11.2017

Since the business organisations didn't respond to the public consultation on ALS, the unit in charge of the file organized a meeting with three of them (BusinessEurope, UEAPME and EuroChambre).

One came as an observer as was not interested to express views on the file (not pre-empting the possibility to express their views on a later stage). The other two organisations didn't have an official position as there was no consensus among their members. Below some of the points of discussion to give an indication of views in their personal capacity (so not representing the official position yet):

- why doing something for the whole EU and not only where it is relevant i.e. in specific MS without or with inefficient out-of-court systems and high level of NPLs
- some of their members are concerned that in case of transferability to "aggressive" third party investors they will be abused as usually banks in order to preserve their business relationship with their clients and to avoid reputational risks tend to have softer approach
- there is no need to change the system where things work well and there is no problem in SME lending
- useful where there is problem (citing that the interest differential between an SME in Italy and Germany is explained by 80% by the differences in level of (in)efficiencies in recovery value / enforcement procedures)
- in those MS where it is useful the main benefits will come from the reduced risks and hence cheaper lending
- an out-of-court collateral enforcement system in Spain exists but it is not efficient as it is more expensive and takes about the same time and yields similar recovery rates as a judicial one
- SMEs in reality don't look for financing abroad
- suggestion to think about a recommendation as a valid alternative compared to legislative proposal
- agreement with the safeguards which will be inevitably priced in by banks hence reducing the potential benefits

Commission services enquired about the 80% figure (expressing doubts about such an high level) and asked about the possibility of retrieving the source or the papers citing that.

Annex 3 – Who is affected by this initiative and how?

1. Practical implications of the initiative

Under the retained option (*option 2: Minimum harmonisation of extrajudicial collateral enforcement procedures*) a harmonized legal framework for out-of-court collateral enforcement will be established at EU level. This EU framework would aim at a minimum level of harmonization across the EU, building on the characteristics of existing national jurisdictions and seeking to avoid disrupting well-functioning markets. This option will require Member States to transpose the new Directive into national legislation, and the contractual parties (banks as lenders and businesses as borrowers) would have to adjust their businesses to changes in the resulting national frameworks (however given the voluntary nature of the mechanism only if it is agreed so by both parties).

2. Summary of costs and benefits

Table 14 – Overview of benefits

I. Overview of Benefits (total for all provisions) – Preferred Option		
Description	***Amount***	***Comments***
Direct benefits		
Recovery rates on defaulted business loans will increase	The EU modelled recovery rate would increase by up to 10.4 pp. (unweighted EU average)	<u>Banks</u> - This increase will benefit banks in future recession crises (especially small and medium-sized banks[89] in those countries where out-of-court systems don't exist or are not used as not efficient)
Decreased borrowing costs for business loans	The lending rates are expected to go down by about 10 to 18 bp.	<u>Businesses</u> - An improvement of the recovery rate by 10 pp. is on average associated with lower lending costs by 10 to 18 bp. The Commission analysis suggests that this pricing effect would be stronger for small borrowers (by about 40%).
Indirect benefits		

[89] According the EBA, NPL ratios are highest in the small to medium category of banks

Foster the development of the secondary market for NPLs	Not quantified due to modelling uncertainty but see box on section 8.1 on the linkages to the NPL secondary market initiative	Third party NPL investors
Lower need for actual provisioning on secured loans	Not quantified due to modelling uncertainty but see box on section 8.1 on the linkages to the prudential backstop initiative	Banks
Administrative cost reductions for courts as more there will be a reduction in the number of cases handled in courts	Not quantifiable given the heterogeneity of judicial systems in Member States and the lack of data	Administrations and indirectly taxpayers

Table 15 – overview of costs

II. Overview of costs – Preferred option									
		Citizens/ Consumers		Businesses				Administrations	
		One-off	Recurrent	One-off		Recurrent		One-off	Recurrent
				Banks	Debtors	Banks	Debtors		
Introduction of AECE in loan contracts	Direct costs	-	-	-		-[90]		-[77]	-[77]
	Indirect costs	-	-	EUR 4,167 – 12,500 per bank[91]	-	-	-	-	-
Publicity of AECE	Direct costs	-	-	EUR 4,167 – 12,500 per bank[92]	-	-	-[93]	-	-
	Indirect costs	-	-	-	-	-	-	EUR 3,000 – 9,000 per register[94]	-

[90] Due the well-developed supervisory framework for MFI, the envisaged change in contract could be complied with and supervised without additional costs.
[91] Estimate based on assumption that one person working full-time will spend 0.5 – 1.5 months on the preparation of the required contract change (at EUR 100,000 annual salary) plus other additional costs such as technical assistance to change the relevant clauses in the loan contracts.
[92] Estimate based on assumption that one person working full-time will spend 0.5 – 1.5 months on the preparation of the required contract change (at EUR 100,000 annual salary) plus other additional costs such as technical assistance to change the relevant clauses in the loan contracts.
[93] It is envisaged that the publicity costs borne by the creditor will remain unchanged.
[94] Estimate based on assumption that one person working full-time will spend 0.5 – 1.5 months on the preparation of the required contract change (at EUR 75,000 annual salary) plus other additional costs such as technical assistance to adapt the IT systems in the registers.

Annex 4 – Analytical methods used in preparing the impact assessment

This annex presents the methodology, the underlying assumptions and the data used to quantify the economic impacts of the three proposed policy options. All three options are forward-looking in the sense that they aim at mitigating future NPL problems, rather than the legacy stocks of NPLs. Therefore, the results of this quantification exercise should be considered with a number of methodological caveats in mind and the figures should be read together with the assumptions and stylised scenarios presented in this annex.

The data used to quantify the effects on recovery rates of secured creditors come from the World Bank Doing Business (WB DB) database's Resolving insolvency section. They correspond to aggregate responses by experts to a common survey case study about the resolution of a defaulted secured loan. The variables used are the '*Time to recovery*', the '*Cost of recovery*' and the typical '*Outcome'* (gone or going concern recovery). We complement these data with lending rates on medium term loans (1-5 years maturity) obtained from the ECB Statistical Data Warehouse (complemented with Bank of England data for the UK). In calculating model recovery rates, we closely follow the approach used in the WB DB database.[95]

A number of important caveats relative to the WB DB recovery rate data and underlying methodology should be mentioned. Firstly, it is important to recall that these model recovery rates may not reflect actual recovery rates in an economy, as they are based on expert judgement of the survey respondents on a common case study. Secondly, actual recovery rates on a loan depend on the level of viability of a debtor or on the quality of its assets. In this assessment, the model recovery rates were used at the aggregate level to obtain an estimate of the order of magnitude of the total value recovered from future NPL stocks. However, the viability level of those future NPLs may be very heterogeneous and differ from what the WB DB survey case study assumes. Therefore, the estimated total value recovered from NPLs should not be read in absolute terms, but rather in relative terms across the three policy options being assessed. Thirdly, the effects on the time and outcome of the recovery were assumed based on the results of the Commission services' analysis of the mapping of the current situation of extrajudicial enforcement mechanisms. It is assumed that these mechanisms contribute to the broader outcomes of insolvency frameworks, but the existence and extent of this causality effect is a working assumption rather than a certainty.

1. Effect on overall recovery rates

As discussed in section 6.2.1, and highlighted in *Figure 7* on page 20, the presence of extrajudicial enforcement mechanisms seems to be relevant not only in a narrow context of the secured loan itself, but it can also have repercussions on the functioning of the wider insolvency framework. Indeed, our assessment based on the mapping of the existence of out-of-court (OOC) enforcement mechanisms in the EU Member States shows that the existence

[95]. The detail of the WB DB methodology can be found at http://www.doingbusiness.org/Methodology/Resolving-Insolvency

of OOC tools seems to be associated with higher recovery rates in the WB DB database.[96] Specifically, our analysis shows that this is driven by two underlying variables of the modelled recovery rate, namely the Time to recovery and the Outcome.

Although it is not possible to infer causality from this relationship, it seems plausible to assume that at least part of this observed correlation is due to the fact that the presence of expedite and efficient collateral enforcement methods improves the incentives of debtors and creditors to cooperate and find more efficient resolution of financial distress.

In evaluating the proposed options, we therefore assume some degree of convergence of the Time and Outcome variables to a benchmark, as a result of the measures taken under each option. The benchmark is calculated as the median Time and median Outcome among Member States that were identified in our mapping as having OOC mechanisms for both movable and immovable assets. The following convergence of these two values is assumed. On Time, the three options correspond to a convergence of Member States by respectively 25%, 50% and 67% of their gap to the benchmark (1.5 years[97]). On the Outcome, we assume that Option 1 would only achieve partial convergence to the benchmark Oucome (value recovery through restructuring) of 25%, while the two other options would lead to full closure of the gap, as the mere presence of OOC mechanisms is likely to affect the incentives of the debtor to seek solutions to distress at an early stage where restructuring is more likely. Finally, the convergence under Option 1 concerns only Member States that currently do not have OOC procedures for enforcing both movable and immovable assets, as we assume that a soft instrument would have highest chances to be taken up by those Member States. Options 2 and 3 assume convergence of all Member States that are below the benchmark.

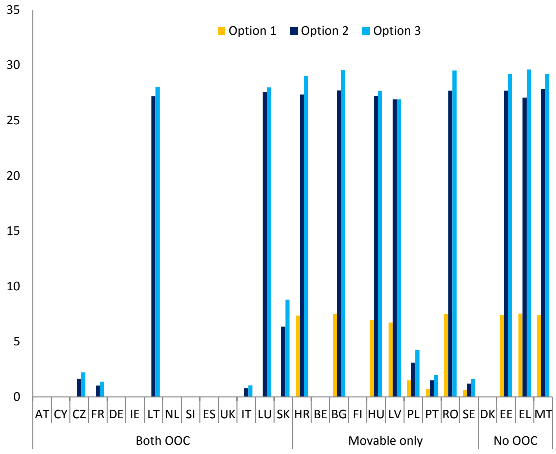
Summary of the options' assumptions on convergence to the benchmark

	Option 1	**Option 2**	**Option 3**
Gap closure of Time to recovery to benchmark	25%	50%	67%
Gap closure of Outcome to benchmark	25%	Full	Full
Which MS converge	Only MS that do not have OOC for both movable and immovable	All MS below benchmark	All MS below benchmark

[96] It is important to stress that the variables in the WB DB database most often correspond to resolution via collective insolvency or restructuring proceedings, rather than through an individual collateral enforcement.
[97] Again, it is important to stress that this value corresponds to the time that typically takes a collective insolvency or restructuring proceeding.

Recovery rates based on the new values of Time and Outcome are calculated using the formula used in the WB DB database.[98] The resulting changes of recovery rates under the three options are summarised in the following graph.

Figure 13 – Illustrative estimates of the impact of the options on modelled recovery rates (pp.)



Source: World Bank Doing Business, Commission services calculations.

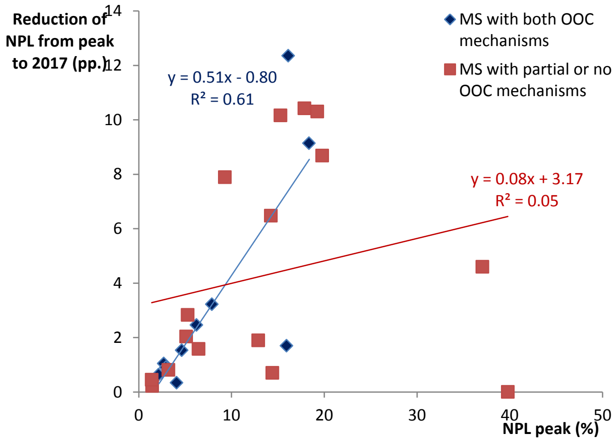
Quantification of the impact under a stylised future NPL scenario

The existence of extrajudicial collateral enforcement mechanisms can have significant effects on the evolution of NPLs in adverse economic conditions. Using the results of the mapping of the existence of extrajudicial enforcement presented in section 6.2.1, *Figure 7* assesses to what extent Member States with a complete OOC tool setup have been better able to cope with their NPL shock compared to Member States where only some or no OOC tools are available. The graph presents the relationship between the peak level of NPLs and the subsequent reduction of that NPL level so far. One would expect that countries that have reached higher NPL levels during the crisis have managed to have a stronger reduction of NPLs thereafter.

One can see that this relationship holds well for countries where extrajudicial enforcement tools were available for both movable and immovable assets: the slope of the curve is clearly positive with a high R-squared. By contrast, for countries with incomplete or no OOC mechanisms, this relationship is much weaker and less clear. Some of those Member States were able to cope with their NPL shock relatively well, while others have been able to reduce their NPL only very little. This situation would be consistent with an interpretation that efficient OOC mechanisms are a sufficient condition for a swift adjustment following an NPL shock. However, they are not a necessary condition, for example in cases where the legal and judicial systems are very well functioning.

[98] See http://www.doingbusiness.org/Methodology/Resolving-Insolvency for further details.

Figure 14 - *Non-performing loan ratio for MS with out-of-court collateral enforcement and for those with incomplete or absent OOC mechanisms (%)*



Source: ECB SWD, Commission services analysis

Given the likely relevance of extrajudicial enforcement procedures for the development of NPLs, the economic impacts of the proposed options were assessed on an illustrative future NPL scenario. The aim is to give an order of magnitude of the level of NPLs in a stylised adverse economic environment and provide an order of magnitude of the positive effect of improved OOC mechanisms on recovered value. The following steps are performed:

- We start by assuming that the stylised future peak NPL rate for each Member State is an average of a common component and of a country-specific component. The former is assumed to be the median of the NPL rate peak for all EU Member States in the latest crisis period. The latter is assumed to be the actual peak of each country in the latest crisis period.
- We next use this peak total NPL rate together with data from the 2016 EBA EU-wide Transparency Exercise to estimate the peak corporate NPL rate for each MS.[99]
- We obtain the level of peak corporate NPLs in EUR million that are secured by collateral by applying the above corporate NPL rate to the level of MFI lending to non-financial corporations as at 2016[100], and applying the share of secured loans in total loans. Both of these indicators were calculated from ECB SDW data.
- Finally, the level of secured corporate NPLs split between large companies and SMEs is performed using again the 2016 EU-wide Transparency Exercise data.

The recovered value from secured corporate NPLs in this stylised future NPL scenario in the baseline case is obtained by applying each MS's typical recovery rate calculated from the World Bank Doing Business data to the calculated future stock of secured corporate NPLs. This yields a total of EUR 345,967 million.

[99] More specifically, we use the EU value of the share of corporate NPLs in total Non-performing debt exposures, and the share of corporate loans and advances in total debt instruments.
[100] Implicitly we make the assumption of no nominal indebtedness change, i.e. corporate indebtedness as a share of GDP would be decreasing over time with nominal GDP growth.

The additional recovered value in each of the three options is obtained by applying the improvement of the typical recovery rate (in pp.) to the stock of secured corporate NPLs, yielding respectively for options 1, 2, and 3 EUR 1,991 million, EUR 8,083 million and EUR 8,965 million.

Quantification of the impact under on future corporate borrowing costs

In order to quantify the effects of the proposed collateral enforcement measures on companies' cost of borrowing, we use the results of AFME (2016). The report presents a model of the effects of recovery rates in insolvency on corporate borrowing spreads, using a micro-econometric panel study using individual bond yield spreads. The model specification that we consider as the most relevant is one which controls for unobserved country specificities using country fixed effects, yielding a coefficient of -0.0178, i.e. a 10 pp. improvement in recovery rates is associated with approximately 18 basis poins reduction in the corporate borrowing cost.

Table 16 – AFME estimates of impact of recovery rates on corporate yield spreads (selected parts presented)

	(3) With recovery and country dummies
Time trend (days)	0.000380***
Time to maturity (days)	0.000189***
Credit rating (notch)	-0.184***
Missing beta §	0.0285
Beta	6.996***
Missing bid-ask §	1.274***
Bid-ask (% point)	0.0676***
Recovery rate (% point)	-0.0178***

Source: Presented are selected parts of Table 1, AFME: "*Potential economic gains from reforming insolvency law in Europe*", February 2016.

In order to corroborate the results presented in AFME (2016), we develop a simple panel data model at the country level using monthly data of the MFI lending rate to companies from the ECB SDW. We use loans lower than EUR 250,000 as a proxy for lending to SMEs, and loans higher than EUR 1 million as a proxy of lending to large companies. Our results confirm the order of magnitude of AFME, albeit with coefficients somewhat smaller than in the AFME report and with a less obvious statistical significance (ranging from -0.008 to 0.014). The effect seems to be stronger on SMEs, both statistically and economically. We use our results to set a lower bound of the effect of recovery rates on borrowing costs of 0.01, i.e. a 10 pp. improvement in recovery rates leads to a 10 bp. reduction in corporate borrowing costs.

Table 17 - Estimates of impact of recovery rates on corporate borrowing costs

	Lending rate (SME)			Lending rate (Large)		
	OLS	**Panel RE**	**Panel FE**	**OLS**	**Panel RE**	**Panel FE**
Sovereign yield	0.307***	0.232***	0.229***	0.340***	0.278***	0.279**
	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.04)
3-month rate	0.798***	0.689***	0.689***	0.410***	0.543***	0.543**
	(0.00)	(0.00)	(0.01)	(0.00)	(0.00)	(0.02)
Recovery rate	-0.011***	-0.014***	-0.014*	-0.010***	-0.009	-0.008
	(0.00)	(0.00)	(0.09)	(0.00)	(0.23)	(0.45)
Constant	3.822***	4.390***	4.354***	2.608***	2.752***	2.608**
	(0.00)	(0.00)	(0.01)	(0.00)	(0.00)	(0.04)
N	1521	1521	1521	1246	1246	1246
R2-adj.	0.437	n/a	0.415	0.366	n/a	0.350

p-values in parentheses
* p<0.10 ** p<0.05 *** p<0.01

Source: ECB, Eurostat, World Bank Doing Business data. Commission services analysis. Note: Three regressions of aggregate lending rates to SMEs and Large companies are presented (ordinary least squares, panel regression with random effect, panel regression with fixed effect). Presented p-values are based on clustered standard errors.

The total annual savings are obtained by multiplying the reduced borrowing rates with the stock of secured corporate lending obtained from the ECB SDW, assuming it will remain constant in nominal terms. It is important to note that this level of savings would be achieved only over a longer horizon, once the stock of outstanding loans is fully rolled.

Annex 5 – Main features of national out-of-court collateral enforcement mechanisms in the EU

Mapping of out-of-court enforcement mechanisms in Member States – Summary table

MS	Is out-of-court realisation of assets permitted for security over IMMOVABLE assets?	Is out-of-court realisation of assets permitted for non-possessory charge over MOVABLE property?	Key features
Austria	YES	YES	either public auction or private sale if the object holds an official market or stock price
Belgium	NO	YES	10 days after notification, the creditor can ask a bailiff to organise a public sale (auction) or private sale or the renting/leasing of the asset.
Bulgaria	NO	YES	Appropriation or private sale. The creditor is required to act with the care of a "good merchant
Croatia	NO	YES	Sale through a notary public or through real estate agency upon agreement of all parties.
Cyprus	YES	YES	introduced recently in 2014 - private auction which does not involve a government agency, with specific time limits on subsequent steps in the procedure, which is subject to a judicial review only where strictly necessary
Czech Republic	YES	YES	Security transfers are used very rarely in banking practice. If at all, used for receivables used as collateral
Denmark	NO	NO	n/a
Estonia	YES, but minimum court involvement needed	NO	n/a
Finland	NO	YES	Creditor notification that collateral will be sold if the claim is not paid within a certain period of time, at least one month. If real estate solely or mainly as a permanent residence by the collateral owner the period of time

			must be at least two months.
France	YES	YES	*Fiducie, hypothèque and cession des créances professionnelles dite "cession Dailly*. *P*acte commissoire allows the bank to become the owner of collateral automatically upon borrower's default. Consumers are also included.
Germany	YES, but minimum court involvement needed	YES	For movable assets, creditor can ask an enforcement officer to sell the assets on his behalf, or a direct sale can be used, or creditor can be permitted to take possession of the assets. For immovable assets, agreement for creditor to become owner of the property upon debtor's default can intervene only ex post, . Creditor has to go to court to obtain a title for enforcement. Such title can be obtained in accelerated proceedings where the court decides on the basis of the mortgage deed only and the debtor can bring objections only afterwards.
Greece	NO	NO	n/a
Hungary	NO	YES but unclear how broad the scope is	2014 new Hungarian Civil Code prohibits security agreements with a fiduciary element
Ireland	YES	YES	Most common procedures are the appointment of a receiver and the power of sale conferred on mortgagees. A receiver has an obligation to obtain the best price for the secured assets. A prudent receiver will require evidence of market testing and an independent valuation.
Italy	YES	YES	the new law was introduced quite recently - appropriation is the enforcement mechanism

Latvia	NO	YES	Enforcement procedure through sale. The scope includes natural persons if the pledged property is expressly mentioned in the Commercial Pledge Act (vehicles, boats, planes, shares, intellectual property, herd).
Lithuania	YES	YES	Sale through notary.
Luxembourg	YES, but minimum court involvement needed	YES, but minimum court involvement needed	Commercial pledges may be enforced by the pledgee who is already in possession of the asset, and after serving a summons to pay, by seeking a court decision. Court decision fixes the conditions of the sale by public auction. For pledges over general business, upon the default of the debtor, the pledgee must notify pledgor and attach the pledged assets without a judicial order. Pledgee must request an authorisation from Court to sell assets.
Malta	NO	NO	n/a
Netherlands	YES	YES	All parties and collateral assets are eligible. Private sale requires court authorisation. Secured creditors can enforce right in bankruptcy, unless court suspended such enforcement.
Poland	NO	YES	All parties are eligible. Only registered pledges of moveable assets (excluding ships) are enforceable OOC. Appropriation and public sale are foreseen.
Portugal	NO	YES	All parties can agree on an extrajudicial enforcement of a pledge of moveable assets, via private sale. Obligation of "fair market" price in sale.
Romania	NO	YES	All parties are eligible. Only a mortgage on moveable assets can be enforced OOC.
Slovak Republic	YES	YES	All parties are eligible. Private sale can be agreed contractually and is the only extrajudicial method.
Slovenia	YES (loans originated after 2013)	YES	All parties are eligible.

Spain	YES	YES	All parties are eligible. Only public sale by public notary is available.
Sweden	NO	YES	All parties are eligible. Only movable assets
United Kingdom	YES	YES	All parties are eligible. The framework provides a number of alternative enforcement methods.
Total	**15 YES / 13 NO**	**24 YES / 4 NO**	

Austria

Source of information: Ministry of Justice response and SSM report

Scope (contractual parties of the loan)

No restrictions although the statutory waiting period is reduced in case of corporate transactions (see procedural steps).

Categories of assets used as collateral

A legal framework exists for out-of-court procedures regarding debt recovery for moveable tangible objects as well as bearer and order instruments. In general (outside the scope of the legal framework for moveable tangible objects) the person providing the collateral (especially for immovable objects) and the one receiving it can agree on an out-of-court usage or sale. In this case the following legal provisions should be followed (as per Supreme Court of Justice):

- the agreement on only the best possible sale of the pledge is considered invalid and void, but not the sale at an assessed price
- discretion over the pledged asset granted to the pledgee is considered arbitrary

For immovable assets see below (procedural steps – real estate).

Existence of private sale, auction and appropriation methods

The pledgee can either auction the pledged asset publicly or sell it privately if the object holds an official market or stock price.

Procedural steps

Non real-estate assets: Upon maturity the pledgee must notify his intention to sell the pledged asset to the pledgor as well as state the amount of the remaining claim. Subsequently, the pledgee has to wait for a month to give the pledgor the possibility to repay and prevent the realization of the sale (reduced to one week in case of corporate transaction). Time and place of the auction have to be made public and be communicated to the pledgor and third parties that have a right on the pledged asset. **Objects with a stock or market price can be sold privately by the pledgee, as an alternative to the auction.** In specified cases the creditor is permitted to sell pledged assets before the debt is past due, for example if the deterioration of the assets is imminent.

Real estate sales: before overdue payments occur, the owner/debtor and the creditor may contractually agree that the sale of the property by the creditor is permitted so long as it is not sold at a price lower than the valuation price at the time of the sale. Alternatively, the creditor may be permitted to sell to a person designated by the debtor at an agreed price. After the debt has become past due, bilateral agreements are permitted without any restrictions.

Any other relevant information

The pledgees and pledgors can agree on deviating terms on-out-of-court settlements and usage of the pledged asset (however an agreement where the asset goes to the creditor is invalid and void, as is one where the creditor sells the object at a predetermined price or just keeps it).

Belgium

Source of information: Ministry of Justice response

Scope (contractual parties of the loan)

Consumers are excluded.

Categories of assets used as collateral

Tangible and intangible moveable assets, receivables with the exclusion of immovable assets

Scope (type of security rights)

The new law created a new non-possessory pledge (which had to be registered in a new national registry).

Existence of private sale, auction and appropriation methods

After a delay of 10 days, the secured creditor can ask a bailiff to go ahead with **a public sale (auction) or private sale or the renting/leasing of the asset/collateral.**

Procedural steps

Conditions for out-of-court mechanisms:

- the secured creditor must get possession of the asset/collateral first after debtor's default (after consent by the debtor - if no consent secured creditor must go to court)
- the realisation of asset/collateral should be carried out with due care and should be commercially and economically viable and it is the responsibility of the secured creditor to assure that
- the realisation of asset/collateral can always be contested ex-ante and ex-post
- the debtor or the collateral giver should be informed at least 10 days before the realisation of the asset/collateral takes place

Any other relevant information

The entry into force of the new law is 01 January 2018 and was inspired by Uncitral 2016 model law on security on moveable assets. The philosophy of the new law is to limit the intervention of judges/court only when really necessary.

Bulgaria

Source of information: K&L - Gates European Insolvency and Enforcement Country Guide 2017

Scope (type of security rights)

Together with the mortgage, the most commonly used secured instruments include non-possessory (registered) pledges. Registered pledges are a type of security instrument that creates limited rights *in rem* over certain classes of assets without the need for physical delivery or control by the creditor. Assets that may be provided as security under a non-possessory registered pledge include movable assets (including unfinished goods and raw materials), accounts receivables, company shares in limited liability companies, securities and certificated securities. **One of the main benefits of registered pledges is that they can be enforced out-of-court, without the need of obtaining prior judgment, writ of execution or any other form of court action**. The foreclosure starts with the secured creditor filing a statement with the relevant public registry with which the pledge is registered and sending a separate foreclosure notice to the pledgor.

Existence of private sale, auction and appropriation methods

As the moment of filing of the foreclosure statement the secured creditor is entitled to take possession of the pledged asset and/or take measures to preserve its value. As of that moment the floating charges freeze and crystallise with respect to any assets that are considered part of the floating pool. **The secured creditor may choose the sale method** (as opposed to the procedure under the Bulgarian Civil Procedure Code). **However, the secured creditor is required to act with the care of a "good merchant"**. For the purposes of the foreclosure, the secured creditor has to appoint an accountant that acts as depository for collection and distribution of the proceeds from the sale. Upon the sale of the collateral, the depository draws a list of the secured creditors and distributes the foreclosure proceeds in accordance with their priority or share of the secured claim, if they enjoy the same priority.

Any other relevant information

The mortgage is a security instrument creating rights in rem in favour of a creditor over property of the mortgagor (the debtor or a third-party mortgagor). Mortgages can be created only with respect to land, buildings, construction rights (superficio) and other real estate rights or with respect to ships or aircrafts. **When enforcing a mortgage the secured creditor only has the right to sell the mortgaged property through a public official (bailiff) and to receive the proceeds from such sale in satisfaction of its claim. The sale process is organised as a public auction, which is subject to the control of the courts. The secured creditor is not entitled to take possession or ownership of the mortgaged property, but has the right to participate as buyer in the public auction and to bid with its claim.** The mortgage is established by means of a written contract in the form of a notarial deed registered with the Real Estate Registry in Bulgaria. The registration of the mortgage is a condition for its validity and not only a perfection requirement. Creation of a mortgage involves payment of certain notarial and registration fees calculated as a percentage of the secured debt. **Under the Bulgarian Civil Procedure Code, the creditor is entitled to commence enforcement of the security under the mortgage deed by directly obtaining a court order for immediate payment together with a writ of execution.** Thus, the mortgagee is not entitled to first obtain a final and effective court judgment in order to proceed with enforcement, which significantly reduces the time and costs for enforcement as compared to non-secured debt. The court payment order with writ of execution is being issued in a formal procedure where the creditor does not have to prove its receivables, but only file a standard application form and pay a statutory fee of 2% of the security interest. On the grounds of the writ of execution, it is entitled to commence enforcement proceedings through a bailiff.

Croatia

According to EBRD assessment the out-of-court realisation of assets is permitted for non-possessory charge over movable property whereas for security over immovable assets the enforcement must be done via court administered enforcement proceedings. However, the court may entrust the sale to a notary public. In addition, if all the interested parties (mortgagor, mortgagee, holders of other real rights) agree, the sale can be done through real estate agency.

Cyprus

Source of information: Permanent Representation of Cyprus to the EU

An out-of-Court enforcement tool that Cyprus has adopted in 2014 is the foreclosure process, which was enforced on the 9th of September, 2014 by amendment to the Transfer and Mortgage of Immovable Property Law. The new foreclosure framework allows creditors to arrange a private auction which does not involve a government agency, with specific time limits on subsequent steps in the procedure, which is subject to a judicial review only where strictly necessary.

Prior to this amendment, the disposal of collateral could be achieved only via public auctions organised by the Land Registry Department, a governmental department. By the amendments introduced in 2014, when the debtor is in default, the secured creditor, that has a registered contractual mortgage over the immovable property of the debtor, may carry out a private auction for the sale of this immovable property, without any intervention by the Land Registry Department. This new foreclosure process may be initiated by any creditor, irrespective of whether this is a financial institution, and is applicable against the mortgage/security of all commercial and personal loans, of businesses and natural persons alike.

The secured creditor thus gives an initial notice to the debtor informing him of the default and, at this point, the debtor may request a restructuring according to the Arrears Management Directive (out-of-Court restructuring process provided by financial institution that usually is concluded within 5 months) or referral to mediation (which as provided in the relevant legislation shall be resolved within 2 months) as provided in the said Law. During this period, the debtor may also appeal to Court for any reason, though essentially only to dispute the amount owed to the creditor. Upon failure of any restructuring attempt or any appeal to Court or upon expiry of 120 days since the initial notice, the secured creditor may proceed with the foreclosure of the mortgaged property, giving though two further notices of 30 days each to the debtor ending on the date that the auction is set. During this 30 day period, debtors may apply Court to challenge the foreclosure procedure, only on the grounds related to the service of the notice and its form and content.

If, additionally, during these periods of notice, the debtor secures a protection order from the Court for the stay of proceedings against him- either under a Personal Repayment Scheme as provided in the Personal Insolvency Law for natural persons or under an Examinership as provided in the Companies Law- the foreclosure process is suspended.

Since the entry into force of this amendment to the Transfer and Mortgage of Immovable Property Law, the necessary infrastructure to carry out private auctions were put in place, auction houses were established in all districts and licensed and trained auctioneers undertake the job. To the point that this out-of-Court enforcement of collateral mechanism has been utilized up to date, it has proved to be fairly efficient, effective and, most importantly, expedited.

Additionally, and primarily due to the success of the above mentioned speedy forced sale of collateral, financial institutions also effected, as an alternative, voluntary arrangements of debt-to-equity swap. This is acquiring property from the debtor, usually immovable, in satisfaction of debts. Accordingly, an amendment to the Activities of Financial Institutions Law enforced in 2017, enables financial institutions to acquire, buy, rent and sell immovable property, as well as share capital in other companies, for a specified period of time.

Also, by the introduction of specialised legislation and regulations, Financial Institutions were enabled to sell portfolios of loans, thus enabling the development of secondary markets for NPLs in Cyprus.

Receivership is another out-of-court procedure available to creditors secured by floating charge on the debtor-company. It is a procedure whereby a floating charge holder-creditor appoints a Receiver and Manager on the debtor-company, and consequently also to its assets (as collateral to a loan agreement). Even though, this is an enforcement tool, there have been many cases of restructuring and reorganizing the business via the appointment of a Receiver and Manager, without having to sell all or part of the assets of the Company. The Registrar of Companies, in accordance to Companies Law, acts as an administrative body for registering the floating charge, as well as the appointment of the Receiver and Manager. Any work outs during the Receiver and Manager does not necessarily need to be endorsed to the Courts, unless the parties agree to do so, especially if a dispute between the creditor and the debtor is already before the Court.

Czech Republic

Source of information: Ministry of Justice response and expert group feedback

Scope (contractual parties of the loan)

No limitation in terms of scope except with regards to the limitation on agreements entered into pre-default for SME and consumers.

Categories of assets used as collateral

All types of chargeable/transferable collateral may be subject to the security transactions described below. For tax and other reasons, real estate is usually mortgaged rather than transferred by way of security. Because Czech law allows non-possessory charges of movable assets via a register of charges operated by the Notarial Chamber, as well as for other reasons (mainly having to do with rules on priorities), **security transfers are used very rarely in banking practice**. If at all, they might be used where receivables serve as the collateral.

Scope (type of security rights)

Rigth in rem (i.e. concrete asset) collaterals are: pledge (Section 1309 et seq. of Civil Code - CC),sub-pledge (Section 1390 et seq. of CC), retention right (Section 1395 et seq. of CC) and transfer of right as security (Section 2040 et seq. of CC). There are different out-of-court mechanism for the first three (pledge, sub-pledge, retention right) and the last (transfer or right as security). Transfer of right as security is usually used as a possibility how to secure a loan by claims or other movable assets (under CC, some rules regulating movable assets are applicable to claims as well). Immovable assets are almost always secured by pledge in the Czech Republic.

Existence of private sale, auction and appropriation methods

In regard of pledge, Section 1359 of CC regulates procedure of **fulfilment of secured debt via liquidation of the pledge. Such liquidation can be conducted out-of-court as well, based on written agreement concluded between creditor and the person providing collateral** (i. e. the debtor or a third party) or in auction in a sense of Act No. 26/2000 Coll., on public auctions, as amended. These rules apply to sub-pledge (see Section 1393 of CC) and to retention right (see Section 1398 of CC) as well.

In regard of transfer of right as security no ingression of court is necessary in order to satisfy the creditor. The debtor secures his debt by temporarily transferring a right (i. e. ownership right, right to revenues, etc.) to his creditor by means of a contract on transfer of a right as security. Transfer of a right as security is presumed to be a transfer with a cancellation condition that the debt will be fulfilled (Section 2040 of CC). If the debt is not fulfilled duly and in time, the creditor does not have an obligation to transfer the right back to the debtor. If the right is transferred back after due and timely fulfilment, the creditor gives over all yields of the right against reimbursement of all reasonable expenses incurred in connection with the transfer of a right as security.

The Act on Financial Securing is applied to transfer of a right as security whenever certain specific criteria of the Act are met. These are related to the characteristics of the collateral and parties to contract. The special regime can be negated by agreement of both parties (Section 8 Subsection 2 of the Act on Financial Securing) which means the securing is established in accordance with the general provisions of CC regulating transfer of right as security.

Procedural steps

With respects to charges/mortgages, it is thought that S. 1315 (combined with i.a. S. 1359, 1360 and 1365) allows parties to agree on a private sale or even on forfeiture of the collateral, provided that the charge/mortgage agreement does not (a) allow the chargee/mortgagee to proceed with unlimited discretion as to the method of the sale, or (b) to acquire the collateral at a discretionary price or a price fixed up-front. It is thought that once **the secured debt has become due and payable, the limitations as to the method of sale or setting of the price fall away, except where the chargor/mortgagor is a consumer or a sole proprietor running an SME business**. It is thought that enforcement requires payment default, rather than just non-payment default. With respect to charges/mortgages, the chargee/mortgagee must notify the chargor/mortgagor of commencement of enforcement in writing (S. 1362) and the **chargee/mortgagee may proceed with the sale of the collateral at the earliest after 30 days following such notice** (S. 1364). Finally S. 1360 specifically provides that an agreement on sale outside of an auction is binding on the chargor's/mortgagor's legal successors.

With respect to transfers of title by way of security, S. 2040(2) of the Civil Code contains an assumption that the transfer of the collateral has been agreed with a condition subsequent, the condition being that the secured debt has been paid. S. 2044(1) **provides that where the secured debt has not been paid, the transfer shall become unconditional**. S. 2044(2) provides that where the usual price of the collateral is obviously higher than the amount of the secured debt, the transferee shall pay the difference to the transferor. Finally a transfer of the secured receivable pre-default should thus not have an impact on the transferee's rights under S. 2044.

<u>Any other relevant information</u>

The rules cited here only took effect on 1 January 2014

Denmark

Source of information: Ministry of Justice

No extrajudicial mechanisms for the enforcement of secured loans currently exist in Denmark.

Estonia

Source of information: SSM report, EBRD, Doing Business

Lenders have several legal options to begin judicial enforcement procedures, but in every case there is the requirement of a court judgement/decision. The out-of-court private sale of the pledged property may take place only by mutual agreement between the mortgage lender and borrower. Estonia amended its code of enforcement procedure in 2009/2010 to allow out of court enforcement after notarisation of an agreement allowing for this.

Finland

Source of information: Ministry of Justice

Scope (contractual parties of the loan)

The legislation does not differentiate between corporates and sole traders.

Categories of assets used as collateral

National legal framework in Finland provides an extrajudicial mechanism, which enables a secured creditor to enforce collateral in the form of movable assets. Provisions thereof are in Chapter 10 Section 2 of the Code of Commerce (kauppakaari 3/1734, 10:2 §). **No extrajudicial mechanism for the enforcement of collateral in the form of immovable assets.**

Existence of private sale, auction and appropriation methods

When selling the collateral, the creditor shall also take account of interests of the owner of the collateral, e.g. in choosing the manner of the sale.

Procedural steps

A secured creditor may sell collateral and collect on his claim out of the sale price if:

- The claim has fallen due for payment;
- After the claim has fallen due, an owner of the collateral has been notified that the collateral will be sold if the claim is not paid within a certain period of time, **length of which must be at least one month**; and
- The said period of time has passed and the claim is still not paid.

Even if the aforementioned conditions are not fulfilled, the collateral may be sold if otherwise its value would evidently decrease, thus causing essential damage.

The provisions are mainly discretionary and the parties may agree to depart from them or put them totally aside. However, if the collateral consists of shares that provide a right of possession to an apartment used solely or mainly as a permanent residence by the owner of the collateral, the period of time referred to in paragraph (b) must be at least two months and no exceptions to the aforementioned conditions can be made.

Any other relevant information

If an owner of collateral has been declared bankrupt, the extrajudicial mechanism is not applicable but provisions in the Bankruptcy Act (konkurssilaki 120/2004) apply instead. The extrajudicial mechanism presented not applicable either after the commencement of the restructuring proceedings.

France

Source of information: Government response to the public consultation

Scope

Contractual parties of the loan

Broader than banks and companies and entrepreneurs. It also covers consumers.

Categories of assets used as collateral

Moveable and immovable assets. The main residence of the borrower is excluded.

Type of security rights

Several types of security rights may be enforced out-of-court: la fiducie, l'hypothèque, et la cession des créances professionnelles dite "cession Dailly"[101].

Fiducie was introduced in French law by law n° 2007-211 of 19 February 2007.

In the case of fiducie and cession Dailly, the bank is the owner of collateral from the moment the security is concluded.

<u>Type of enforcement procedure</u>

- Appropriation in the case of Fiducie.

- creditor becomes the owner of collateral automatically upon borrower's default.

<u>Procedural steps</u>

The *pacte commissoire* allows the bank to become the owner of collateral automatically upon borrower's default. This mechanism has been introduced through Ordonnance of 23 March 2006. It can be used in relation to pledges, mortgages or receivables.

<u>Germany</u>

Source of information: Government response to public consultation, internal analysis and K&L Gates

<u>Scope (contractual parties of the loan)</u>

Anyone on either side of the deal, i.e. no restriction for creditors to be only banks, no restrictions for debtors to be entrepreneurs. The debtor's protection is anchored in

- The general provision against immoral agreements (*contra bonos mores*) which precludes taking out collateral in a value in excess of the claim plus a certain safety surcharge, and for examples prevents collateral over all the assets of a debtor;
- Consumer Credit Act;
- the law on general terms and conditions which render certain agreement invalid;
- enforcement and insolvency law which exempts certain personal assets from enforcement, which in practice means that creditors will not accept such assets as collateral in the first place.

[101] Established by law nr. 81-1 of 2 January 1981; article L.313-23 of Code monétaire et financier.

Categories of assets used as collateral: movable and immoveable assets

Movables, both tangibles and intangibles including claims, but separate rules for these. The security right can be created over existing and future assets, but they must be determined; the rich case law, however, reveals that certain manners of determinability suffice, e.g. all assets contained in a determined room over time, which makes a revolving security right/“floating charge” possible. Also, it is possible to agree for the debtor to replace assets (e.g. when buying a new machine or for security rights in an inventory which is revolving, with parts used in production and new stock incoming) with an anticipated title transfer in such assets at the moment of granting the collateral.

Securable claims: Present but also future or conditional claims. The collateral can also be used to secure claims which the parties did not anticipate when creating the collateral, by mutual agreement to include such claims.

Scope (type of security rights): retention of title, chattel mortgage for movable, and mortgages and land charges for immovable assets

Type of enforcement procedure: appropriation

Procedural steps

Security interests in real property- mortgages and land charges- may be enforced under the Act on Enforced Auction and Receivership (*Gesetz über die Zwangsversteigerung und die Zwangsverwaltung*). In this case, the **secured party** may initiate the foreclosure proceeding, which is not necessarily directed at a foreclosure auction, but may also result in a receivership covering the proceeds from the administration of the collateral.

The holders of the security interests are entitled to the proceeds in accordance with the rank of the security interest, i.e. a first ranking mortgage has priority over a second and third ranking mortgage. Security interest holders’ claims are, however, subordinated to specific claims and entitlements, such as property tax claims relating to the collateral or in the case of a receivership, claims for compensation of costs for the maintenance of the col-lateral.

Any other relevant information

- Enforcement outside insolvency for the movable assets instruments is determined by agreement between the parties which can allow for the creditor to obtain ownership and to sell the collateral on the market. Enforcement outside insolvency for real estate mortgages allows for an upfront agreement for the debtor to accept immediate enforcement, limiting court involvement. For real estate, no upfront agreement to a market sale permitted to protect the debtor. However, in auction process, real estate can be sold at a certain percentage of (i.e. below) market value.
- Enforcement in the debtor's insolvency gives the collateral taker a right to pre-emptive satisfaction which results in speedy realization of the collateral by the insolvency administrator, before the insolvency proceedings over the remaining estate are sorted out. The insolvency administrator may decide to turn over movable assets to the creditor for sale on the market, or undertake a market sale himself, where preferable to an auction. For real estate, realization below market value possible but limits in relation to the market

value apply.

Movable assets: Enforcement outside insolvency: It is considered permissible for creditor and debtor to agree that the creditor, in case of the debtor's default, shall be allowed to take the assets in his possession and/or to sell them on the market. Such agreement is frequent in practice.

The standard way of enforcement would be as follows: If the debtor does not voluntarily relinquish possession (direct possession rather than the intermediated form) to the creditor, the creditor will have to obtain a title in court for his claim to bring his property into his possession (*vindicatio*). Based on such title, the creditor can ask an enforcement officer to sell the assets on his behalf, or a direct sale can be agreed between the parties in advance, or the creditor can be permitted to take possession of the assets without involving the court and enforcement officer. The proceeds exceeding the secured claim, if any, will have to be turned over to the debtor. There is no expert's opinion and the assets can be sold also below market price, but the creditor has to make an effort to obtain good consideration, otherwise he will be liable for damages; in order to defend himself against such liability, the creditor will often obtain an independent expert's opinion before the sale on the market.

Immovable assets- Enforcement outside insolvency: Agree for the creditor to become the owner of the property upon debtor's default only after the fact, no anticipated agreement possible. The creditor has to go to court to obtain a title for enforcement. However, to speed up foreclosure, such title can be obtained in accelerated proceedings where the court decides on the basis of the mortgage deed only (*Urkundenprozess*) and the debtor can bring objections only afterwards. The parties can also agree in advance, in a notarial deed, for the debtor to accept immediate enforcement (*Unterwerfung unter die sofortige Zwangsvollstreckung*), which will entitle the creditor to mandate the enforcement officer without court involvement, and the debtor has to bring a claim in case of objections.

If foreclosure is effected through an auction of the property, the property can (and often will) be sold below market value. There are certain minimum offers, relative to the market value as estimated by an independent expert, which decrease if the property cannot be auctioned off at the first appointment.

General remarks:

The non-possessory security right for movables is title transfer by way of security (*Sicherungsübereignung*). The non-possessory security right cannot be in the form of a pledge but has to be in the form of title transfer with the accompanying agreement to only use the title acquired in the goods as collateral. While outside the Civil Code, this instrument has been acknowledged in various other statutes and in the course of its long history (since about 1880) has produced a great amount of rich case law, which could help to define elements of any non-possessory collateral instruments (e.g. the determinability of the assets). Such a title transfer is treated like a pledge in individual enforcement and in insolvency. It can be tailored to the parties' needs with great flexibility, allowing for accommodation of all salient economic elements of the IT non-possessory pledge. Its efficiency lies in the speediness of enforcement, where various ways including a direct sale can be agreed, including in the debtor's insolvency, where pre-emptive satisfaction grants the speedy realization (which can also be direct sale by the creditor, upon the insolvency administrator's discretion) of the collateral.

For real estate, only mortgages are used, which are non-possessory anyhow. No conditional title transfer is possible for real estate but the conditional right to request title transfer later on can be secured by a priority notice (*Vormerkung*) in the land register; mortgages in their various forms are considered more practical.

These security rights are largely abstract/remote from the underlying claim, i.e. they are unaffected by a contestation of the underlying repayment claim (for mortgages, only the more common variety). From a strictly DE law viewpoint, one would have to speak of the collateral taker (instead of the creditor) and the collateral provider (instead of the debtor), also to indicate that collateral can be posed by third parties (important e.g. in group structures where an affiliate/subsidiary can secure another group company's debt). The feature which makes security rights under German law particularly flexible is, in effect, the abstractness of the transfer of the right in rem from the underlying loan contract between the parties, which in DE law means that either contract is valid independent of the validity of the other and objections arising from the loan contract have, in principle, to be raised between the parties but will not affect the circulation of assets. While the most important single feature, this is also so fundamental as to render it impossible to impose on other national civil laws.

This means that DE law will not speak about the loan contract when discussing security rights, but about the security rights themselves and the security/fiduciary agreement accompanying the creation of the security rights, which puts in place the respective rights and obligations of both creditor and debtor as regards the creation of the security, the treatment of the assets, what constitutes default, and the manners of enforcement permitted, all within boundaries of cogent law and a vast array of case law. The strong feature of the DE law is the strong case law around the rather old provisions, which provide a high level of legal certainty and could be a point of reference for designing the elements of a harmonized collateral instrument, e.g. as regards determinability of the assets which is likely to be an issue with all non-possessory collateral instruments.

While enforcement requires a title, to be obtained in court, such title can be obtained quickly if all prerequisites emanate from a written deed (*Urkundenprozess*). Furthermore, debtors can agree, already when creating the security right, to immediate enforcement, meaning the creditor can directly ask an enforcement officer (*Gerichtsvollzieher*) to proceed to enforcement. Finally, for movable assets, creditor and debtor can agree in advance that the creditor takes possession and sells the assets on the market (the formerly banned *lex commissoria*); for real estate, the insolvency administrator can give such right to the creditor.

No non-recourse provision, but it could usually be agreed between the parties; not usually an issue since security rights abstract from the loan. In practice, the unsecured part of the claim will not have much value in insolvency and will be handled entirely separately in both individual enforcement and insolvency.

No special security rights exist just for banks. Putting in place a special security right just for banks or other entities which are licensed to conduct lending on a commercial basis could be inconsistent with the CMU goal to encourage non-bank lending, e.g. loan-originating funds or peer-to-peer lending. However, banks are restrained in the use of general terms and conditions for agreeing to certain features considered detrimental to the debtor if the debtor is a consumer###. In practice, this means that certain features will not be agreed with consumers since too cumbersome, but only with entrepreneurs and for loans of a certain size to make specific agreements/deeds worthwhile.

Movable property:

Type of security right: For movable assets, a non-possessory security right exists in the form of full title transfer by way of security (*Sicherungsübereignung*). This title transfer by way of security is not explicitly mentioned in the German Civil Code. However, it is based on specific features of the German Civil Code, has been acknowledged by the courts for over one hundred years, and is meanwhile explicitly mentioned in other Statutes, including the Code of Civil Procedure (for enforcement actions) and the Insolvency Code, where to a certain extent it is treated like a pledge (which for all practical matters it has come to replace; the title transfer by way of security in fact developed in lieu of a non-possessory pledge since a pledge always requires transfer of possession to the collateral-taker, which deprives the debtor of the right to use, burdens the creditor with the possession and creates publicity shunned by debtors). The title transfer can be unconditional with an agreement for later re-transfer, or conditional upon the condition subsequent of payment of the secured debt.

The title transfer also, in theory, requires transfer of possession. However, DE law allows for transfer of possession to be substituted by creation of “intermediated possession” of the creditor, meaning an agreement by which the debtor acknowledges to hold possession solely on behalf (as an intermediary) of the creditor (*Besitzkonstitut*). Such intermediated possession can be anticipated for incoming assets to allow for a revolving security. The “substitute for possession” is not transparent for third parties and thus quite a departure from the traditional concept of possession in property law. This feature is rather unique in the EU and the lack of transparency is the reason why the instrument of title transfer by way of security has not been acknowledged or accepted by courts in other MS. There is no register for title transfer in movables by way of security.

The title transfer is accompanied by a separate agreement between creditor and debtor providing for their respective rights and obligations with regard to the assets. While the creditor obtains full title, he holds that title as the debtor's fiduciary. If the creditor breaches the terms of this agreement, he is liable to the debtor for damages. Extensive case law has shaped the permissible content of this agreement between creditor and debtor. It allows for all features of the IT non-possessory pledge to be agreed between the parties. For claims, correspondingly, a full assignment by way of security (*Sicherungsabtretung*) exists and in practice has all but replaced the pledge over claims, for similar reasons.

Greece

Source of information: SSM report

The Bank of Greece has indicated that there is no legal framework for rapid out-of-court collateral enforcement. Collateral enforcement and foreclosure measures in broader terms were generally unfavourable in Greece, mainly because of the super-seniority of State claims (tax, social security, etc.) compared with all other creditors' claims in in-court proceedings. Therefore, banks had little incentive to proceed with collateral enforcement and liquidation. As part of the August 2015 MoU obligations, Law No 4335/20159 was adopted, significantly reducing the seniority of public claims. In particular, under the new Law, at least 65% of the proceeds from collateral liquidation are paid to secured creditors.

Further reforms have been introduced by the aforementioned law in order to tackle the issue of the lengthy foreclosure and collateral enforcement procedures. The average length of a foreclosure procedure is 18 months, or even longer for full execution. These reforms refer mainly to the reduction of impediments to enforcement actions, limiting the number of appeals against court decisions and setting shorter deadlines for the completion of the whole process.

Hungary

Source of information: K&L Study on Secured Transactions

Scope (contractual parties of the loan)

Categories of assets used as collateral: movable assets (such as raw material supply, stock,accessories)

Scope (type of security rights): not clear

Type of enforcement procedure: sale

Any other relevant information

On 15 March 2014 the new Hungarian Civil Code (Act V of 2013 on the Civil Code) came into force in Hungary which allows for extrajudicial enforcement.

Prohibition of security agreements with a fiduciary element

The most important change in connection with the regulation of collateral security was the prohibition of transfer of ownership, right to purchase and assignment for security purposes (according to Section 6:99 of the Civil Code: *"**Any clause on the transfer of ownership**, other right or claim for the purpose of security of a pecuniary claim, or on the right to purchase, with the exception of the collateral arrangements provided for in the directive on financial collateral arrangements, **shall be null and void.**"*). **A common feature of these securities was that they could be enforced by creditors simply and easily, but they did not guarantee proper protection of the debtors' interests**. Debtors had very little chance to check, and the creditors could gain ownership of the asset securing the collateral during enforcement. This provided numerous opportunities for creditors to abuse the confidence of debtors. However, there are three exceptions to the nullity of fiduciary collateral arrangements listed in the Civil Code: factoring, financial lease and **retention of title**.

Although the concept of charge over financial assets (i.e. floating charge) has been dismissed by the new Civil Code, it seems that it might be possible to still enforce it out-of-court.

Ireland

Source of information:

Scope (contractual parties of the loan): Not clear if broader than banks and companies and entrepreneurs

Categories of assets used as collateral: moveable and immovable

Scope (type of security rights): fixed charges, mortgages

Type of enforcement procedure

The most common methods of enforcing security under Irish law are: (i) the appointment of a receiver; and (ii) the power of sale conferred on mortgagees. Private sale.

Procedural steps

Appointment of Receiver

Receivership is a contractual remedy for the enforcement of security and court approval is not required. For the enforcement of all forms of fixed charge, either a receiver is appointed pursuant to the terms of the charge deed or the chargeholder becomes a mortgagee in possession of the charged asset.

A receiver has an obligation to obtain the best price for the secured assets so a receiver in a pre-pack will require a significant level of comfort as to the market value of the assets which he will be asked to sell within hours/days of its appointment. A prudent receiver will require evidence of market testing and an independent valuation. The extent of the evidence which can be produced to a proposed receiver to provide comfort that the proposed price represents market value will be case specific.

Mortgagee in Possession

A legal mortgagee has a right to take possession of a property secured in its favour and to sell it. The power of a security holder to go into possession and sell derives from statute and also from the security document. A security document would typically include a clause providing that all of the powers conferred upon a receiver under the security document may be exercised by the security holder directly.

As with the duty of a receiver, if a security holder moves to sell an asset in this manner **it is under a duty to obtain the best price reasonably available at the time of sale.** Normally a security holder would obtain professional advice from an estate agent or valuer as to: (i) the method and timing of sale; (ii) the price to be obtained; and (iii) any steps that should be taken prior to marketing the property.

Other information: an independent valuation is needed.

Italy

Source of information: Ministry of Justice response and Latham and Watkins

Scope

Decree Law No. 59/2016 (the so-called “Banks Decree,” hereinafter the Decree) published in the Official Gazette (the Decree was later amended and converted into law by Law No. 119/2016) and entered into force in June 2017 introduced two important novelties:

1. A new type of security right (floating charge) over movables
2. New Repossession agreements on real estate assets (other than the main residence of the relevant entrepreneurs or their affiliates)

1)The Floating Charge may be granted over non-registered movable assets that relate to the business activity, in order to secure existing as well as future claims (to the extent certain or determinable, provided that a fixed maximum guaranteed amount shall be explicitly indicated in the relevant agreement) relating to the same business activity. In particular, the Floating Charge may be granted over existing and future assets, to the extent certain or determinable, also by way of reference to a specific kind of asset or to a global value. Subject to any contrary provision in the relevant deed of charge, the pledgor may transform or dispose of the charged assets. **The Decree introduces the Italian floating charge regulation (pegno non-possessorio, hereinafter the Floating Charge), a new type of security**. The main differences between the new Floating Charge and the Italian pledge (pegno) provided by Articles 2784 and ff. of the Italian Civil Code (the Italian Pledge) are the following: (i) pursuant to Article 2786 of the Italian Civil Code, to perfect an Italian Pledge the pledgor shall be dispossessed of the charged assets; (ii) on the contrary, **the Floating Charge may be granted over assets which remain in possession of the pledgor, and thus the same asset may continue to be used by the pledgor.**

2) Real estate assets (other than the main residence of the relevant entrepreneurs or their affiliates) may be subject to repossession agreements (known also as Patto Marciano).

The Decree, as amended by Law No. 119/2016, allows the secured creditor(s) to repossess the relevant assets only in the event of non-payment for a period of more than nine months, starting from the maturity of three installments (may be non-consecutive). The period increases to 12 months in the event that, at the date of the first non-payment, the debtor has already paid at least 85% of the relevant financing agreement. The repossession agreement may be included both in new financing agreements and in agreements already existing at the date on which the Decree entered into force. In the latter scenario, the parties shall insert the repossession agreement by amending the financing agreement, in the form of a notarial deed. Where the facility is already drawn and secured by a mortgage, the repossession of the charged asset, conditioned upon the non-payment, shall prevail over any registration (trascrizione or iscrizione) subsequent to the original mortgage registration. Therefore, any security — including any mortgage — which is registered after the original mortgage, ranks lower than the repossession agreement.

Type of enforcement procedure

1) The Law Decree introduces an enforcement system where the new non-possessory pledge is substantially driven by the secured creditor, whereas the involvement of the court becomes residual. Court involvement would be necessary only in case of challenges/opposition in the enforcement methods used by the creditor or where the debtor does not cooperate in the

enforcement and assistance of the public force is therefore required. Indeed in order to enforce the pledge the secured creditor may:

- Sell the collateral, satisfying certain claims on the proceeds up to the value of the secured obligations and transferring to the pledgor any exceeding amount. The assets shall be sold through competitive procedures, also with the assistance of specialized operators, on the basis of the value assessed by experts. The selling procedure shall be adequately publicized, including, in any case, the publication on the Ministry of Justice's (Ministero della Giustizia) website, pursuant to Article 490 of the Italian Code of Civil Procedure.
- Enforce the receivables which have been granted as collateral.
- To the extent provided under the relevant registered Deed of Charge, lease the assets in accordance with the criteria (including as to income deriving from the lease) specified therein and retain the relevant income up to the value of the secured obligations.
- To the extent provided under the relevant registered Deed of Charge (which shall also provide the criteria for the valuation of the assets and of the secured obligations), seize the collateral up to the value of the secured obligations.

The Decree further provides that in case of a debtor's bankruptcy, the Floating Charge may be enforced upon admission of the relevant secured obligations with priority to the bankruptcy real estate (ammissione al passivo con prelazione) and, differently from the Italian Pledge, further to the admission, the secured creditors may dispose of the collateral without court authorization.

2) In case of repossession agreements, the relevant creditor shall notify the debtor or, if different, the owner of the relevant assets, of the relevant creditor's intention to enforce the repossession clause. **Following 60 days from such notice, an independent expert appointed by the competent court, shall assess the value of the relevant assets and notify the creditor, the debtor or, if different, the owner the relevant assets of the its certified report/assessment**. If the debtor raises any objection to the expert's valuation, such objection shall only affect the differential amount to be paid to the debtor and not the creditor's right to enforce the repossession clause.

Latvia

Source of information: Ministry of Justice response

Scope (contractual parties of the loan)

Broader than banks and companies. It includes any secured creditors. a pledgor may be even any natural person if the pledged property is expressly mentioned in the Commercial Pledge Act (vehicles, boats, planes, shares, bonds, intellectual property and herd).

Categories of assets used as collateral: Only movable assets, not immovable ones.

Scope (type of security rights): Only for commercial pledges. Thus possessory pledges and usufructuary pledges are excluded (because in these cases there's no out-of-court enforcement because the possession of the property is transferred to the creditor).

Type of enforcement: Sale, but not clear if public or private sale

Any other relevant information

As a rule, the court decision on the initiation of a restructuring procedure suspends the creditor's right to use out-of-court procedure.

A pledgee of a commercial pledge **may demand the settlement** of a claim out of property encumbered with a commercial pledge even if the claim has not fallen due if the legal protection proceedings (restructuring) or insolvency process begins for the pledgor. However, extrajudicial mechanisms for the enforcement of secured loans by a commercial pledge are very restricted in such cases. But only if the prohibition of the sale causes significant harm to the interests of the creditor (including the existence of the threat of the destruction of the pledged property, or the value of the pledged property has reduced significantly). The decision to permit the sale of the pledged property of the debtor is taken by the court.

Lithuania

Source of information: Deloitte study

Scope (contractual parties of the loan): Not clear if broader than banks and companies and entrepreneurs

Categories of assets used as collateral: moveable and immovable assets

Scope (type of security rights): pledges and mortgages

Type of enforcement procedure: Not clear if public or private sale

Procedural steps: Sale through notary.

Any other relevant information : right to challenge by security provider

Average time and costs for out-of-court collateral enforcement: Minimum 4 to 5 months if no challenges otherwise it may take significantly longer. For challenges the laws provide for short procedural terms (20 days for complaint submission, 7 days for filing an appeal against the decision).

Luxembourg

Source of information: Deloitte, K&L

Scope (contractual parties of the loan)

Not clear if the scope is broader than banks and companies and entrepreneurs.

Categories of assets used as collateral: moveable and immovable

Scope (type of security rights)

Commercial pledges, but a minimum court involvement is needed.Mortgages under certain conditions.

Type of enforcement procedure: public auction

Procedural steps

Commercial pledges may be enforced by the pledgee who is already in possession of the pledged asset, and after serving a summons to pay upon the pledgor, by seeking a court decision. The court decision fixes the conditions of the sale of the pledged asset by public auction.

For **pledges over general business**, upon the default of the debtor, the pledgee must notify (*mise en demeure*) the pledgor and attach the pledged assets without a judicial order. Then, **the pledgee must request an authorisation from the President of the relevant District Court to sell the** pledged assets, in whole or in part. The sale will be done by an official appointed by the President of the District Court. The court order will be enforceable against the pledgor upon its service by a bailiff.

As regards the transfer of ownership as security, upon the default of the debtor, the creditor (transferee) shall be released from its obligation to transfer back the transferred assets to the transferor, until full satisfaction of the secured obligation. The transferee will have the right to exercise all rights in respect of the transferred assets. Transferee may set off the remaining debt of the transferor against the transferred assets, without further notice.

After the set off, the transferor should return any remaining transferred assets to the transferee.

Average time and costs for out-of-court collateral enforcement

6 months for pledges if a court order is required which is the case all the time (the only exception is for financial collateral). If challenged by debtor- 1 year.

If the mortgage deed contained a specific clause (*clause de voie parée*) allowing the mortgagee to sell the real estate through a notary without complying with the legal requirements for the attachment procedure, the public auction may occur approx. 1 month after the summons to pay.

Malta

Source of information: SSM report

No legal measures have been introduced to enable the rapid out-of-court enforcement of collateral

The Netherlands

Source of information: SSM report, Deloitte

Scope (contractual parties of the loan)

All contractual parties are eligible.

Categories of assets used as collateral

Movable or immovable assets can be used as collateral, including primary residence assets.

Scope (type of security rights)

Pledges, mortgages, retention of title.

Existence of private sale, auction and appropriation methods

Public sale with the involvement of a public notary is available. Private sale is available, but requires a court authorisation.

Procedural steps

Debtor has no possibility to challenge property-law security rights.

Any other relevant information

Secured creditors can enforce their right in bankruptcy, except if a court suspends the enforcement of security rights against the debtor.

Average time and costs for out-of-court collateral enforcement

Enforcement of security rights can be immediate.

Poland

Source of information: Ministry of Justice, expert group, Deloitte, K&L.

Scope (contractual parties of the loan)

All contractual parties are eligible. In practice, the instrument is mostly used for loans originated by credit institutions.

Categories of assets used as collateral

Extrajudicial enforcement is possible only on movable assets subject to a registered pledge (excluding ships).

Scope (type of security rights)

Registered pledge. Other securities can be enforced out-of-court only if the debtor has signed a notarial deed of submission to enforcement.

Existence of private sale, auction and appropriation methods

Appropriation and public sale by a public notary are foreseen for registered pledges.

Procedural steps

The pledgor has to notify the pledgee about its intention to enforce the security right, opening a 7-day period for satisfying the claim or appealing to the court. After that period, the pledger has to transfer ownership of the asset.

Any other relevant information

Enforcement of security right is in general suspended in insolvency.

The security and the rights to enforcement can be transferred, if the transfer of security is properly registered.

Average time and costs for out-of-court collateral enforcement

The time depends on many factors, in particular the reaction of the pledgor. In the best case, the procedure can take a couple of weeks.

Portugal

Source of information: SSM report, KL Gates

Scope (contractual parties of the loan)

All contractual parties are eligible.

Categories of assets used as collateral

Extrajudicial enforcement is possible only on movable assets subject to a pledge, if agreed by parties in the contract.

Scope (type of security rights)

Pledge

Existence of private sale, auction and appropriation methods

Private sale is the only method.

Any other relevant information

There is an obligation to sell pledged assets at their fair market value, which in practice pushes the creditor to obtain a credible valuation of assets prior to the sale. The creditor cannot become the acquirer of pledged assets.

Romania

Source of information: EBRD, Deloitte, K&L Gates

Scope (contractual parties of the loan)

All contractual parties are eligible.

Categories of assets used as collateral

Extrajudicial enforcement is possible only on movable assets. There is a legal gap on intangible movable assets (such as pledged shares),

Scope (type of security rights)

Mortgage of movable assets.

Existence of private sale, auction and appropriation methods

Public sale and private sale are available for parties to be chosen in the mortgage contract. Appropriation is possible if debtor has given consent to it following the default, and if concerned parties were notified.

Procedural steps

The law imposes notification rules to debtor and third parties.

Any other relevant information

Obligation to perform the sale on commercially reasonable terms (usual commercial practices if regulated market, or following rules defined in the mortgage contract if no standard market).

Slovakia

Source of information: Ministry of Justice

Scope (contractual parties of the loan)

All contractual parties are eligible.

Categories of assets used as collateral

All types of immovable and movable assets.

Scope (type of security rights)

Pledges of immovable and movable assets.

Existence of private sale, auction and appropriation methods

Enforcement method to be agreed in the contract (private sale, direct sale by agent, private tender). All methods except the private sale require an enforcement title (court order or notarial deed agreed by debtor in default).

Procedural steps

a secured creditor has to inform the debtor (and the collateral owner, if he is a different person), that the collateral will be realized as well as about the way of realization. As mentioned, the collateral may be realized

- by way stipulated in the contract or
- by selling the pledge at a voluntary auction, or
- by enforcement (here a court judgment is necessary).

The announcement has to be done in written form to the owner of the collateral 30 days prior to the start of realization. The creditor has also to inform the registry where the pledge is registered. Generally all collaterals are registered in a registry, although there is not one centralized registry for all collaterals. There is however a centralized registry of voluntary auctions[102]. After stipulated period during which the debtor is not entitled to dispose of the collateral, the secured creditor may start the realization and he acts in the name of the collateral owner. The collateral possessor has an obligation to cooperate.

Sale by way stipulated in the contract

[102] http://www.notar.sk/%C3%9Avod/Not%C3%A1rskecentr%C3%A1lneregistre/Dobrovo%C4%BEn%C3%A9dra%C5%BEby.aspx

There are specific stipulations about sale of collateral by way stipulated in the contract which aim at protection of the debtor. Mainly the secured creditor has to sell the collateral with due care and for usual price, a written report about the process of sale must be sent to the collateral owner and the value of proceeds and costs of sale (these are to be borne by the collateral owner) have to be proven by the secured creditor.

Voluntary auction

Sale by the way of voluntary auction is regulated in a separate Act. It is usually used for realization of immovable by the collateral creditors. These are usually banks or building administrators (for block of flats) because in Slovakia a statutory secured right (with the flat as a collateral) arises if the flat owner does not settle payment connected with the use of a flat or payments connected with the house. The description of the voluntary auction process is given mainly to the sale of immovable as it tends to be common and has specific safeguards. However the vast majority of this process is identical (or less stringent) for other types of collateral as well.

Enforcement via voluntary auction sale offers twofold safeguards for the collateral owner (debtor, here we presume that it is the same person) – before and during the process of sale and after the sale.

The first type of safeguards include said written announcement to the owner 30 days prior to the start of realization, on-line publishing of auction, low cost for attendance of the auction (an entrance fee is maximum 3,32 Euro, apart from the duty to make a deposit if the person wants to bid), ban for certain persons to bid at the auction (connected parties to the auctioneer but also to the debtor), assessment of the value of the collateral (for more valuable collaterals) by expert opinion, possibility of the debtor to challenge the expert opinion on the value of collateral, possibility of repeated auction, obligatory control by notary public in case of auctions on immovable, limiting the lowest bid (specifically if the debtor has his administratively registered residence in the immovable). However, compared to the court enforcement, the auction is **not approved** by the court.

The second type of safeguards is the general possibility of the owner to challenge the auction within 3 months after the auction at the court and claim that the enforcement contract had been invalid. Article 39a of the Civil Code on usury available only for consumers broadens conditions of invalidity of contracts for misuse to legal acts made under distress, inexperience, recklessness etc. providing that mutual contractual settlement is grossly imbalanced. In exceptional cases a natural person (whether a consumer or a sole trader) may challenge the auction even after the passing of the 3 months period. This exceptional form of protection can only be applied if three conditions are fulfilled at the same time – the reasons for invalidity of auction are connected to a criminal offence, the object of the auction in question is an immovable and the immovable is the administratively registered residence of the debtor. Such legal provisions were introduced on the basis of long-term abuse of the weaker contracting party in financial services where the consumers often had to pay disproportionate payback for loaned financial means. The abuse of the auction system was done via unduly diminished price of immovable at the auction and restricted access to consumers´ personal items including their documents which often led to passing the 3 months period for filing the challenge action.

The process of auction of immovable entails the following steps (in given order)

- said general written announcement of the enforcement creditor to the debtor
- conclusion of a contract of the enforcement creditor with the auctioneer
- communication with the collateral owner
- online publication of information about the auction
- drawing up the expertise opinion or expertise assessment (in case of lack of cooperation with the owner) on the value of collateral
- setting the place and date of auction, dates of inspection of immovable
- 2 inspections
- auction
- drawing up a notary report
- publishing the result of the action
- handing the immovable over

The process of auction cannot be launched for collateral in form of immovable if the value of the secured debt (without accessories) is lower than 2 000,- Euro. This principle mirrors the principle in the Act on judicial enforcement pursuant to which it is not possible to sell an immovable for minor debt. Again, this protection was introduced on the basis of abuse of the system mainly to the detriment of consumers.

<u>Any other relevant information</u>

Ministry of Justice pointed out to frequent experience of abuse which led to many legislative changes and protection of consumers in exceptional cases. There are some specific rules concerning the protection of consumers in ensuring conveyance of a right as well as income deduction, which we are willing describe in detail if required.

There was especially abuse of consumers by debt collectors. These often try to enforce the debts from consumers on behalf of secured creditor before the actual sale of collateral and they unduly interfere in consumers´ rights. Therefore a specific clause was introduced in the Act on protection of consumers which is comprised of limiting the costs for debt collection that can be enforced from the debtor (consumer) to the amount of the actual loan. Also debt collecting companies cannot personally visit the debtor at work or in his household and during specifically stipulated times and dates (after 6 p.m., during national holidays etc.).

Obligation of sale with due care, and in usual conditions.

Link to insolvency

In general, at some stage of insolvency or discharge procedure the extrajudicial enforcement mechanism is discontinued and the insolvency practitioner handles the use and sale of the collateral. However there are some exceptions, namely for voluntary auctions. In Bankruptcy the discontinuity comes with at the moment of declaration of bankruptcy which is a third (and main) stage of bankruptcy proceeding (Filing a motion to the court – opening a bankruptcy proceeding and examination of the conditions by the court – declaration of a bankruptcy over the debtor by the court). If prior to the declaration of bankruptcy an item in auction is adjudicated and this item is liable to the bankruptcy and the adjudicataire has paid to the auctioneer the highest bid, the ownership title and the other rights to the item in auction shall pass over to the adjudicataire. The proceeds of the auction shall become an integral part of the relevant bankruptcy estate and the expenses of the auction shall become a claim against the relevant bankruptcy estate; if the auction is organized upon motion of a creditor holding a secured debt, the proceeds shall be paid to the creditor holding the secured debt up to the amount of its secured debt, as if no bankruptcy order were made.

However, if prior to the declaration of bankruptcy the auction has not started, the auction shall be refrained from. The loan is then treated as a classic secured loan in bankruptcy.

In restructuring the auction can take place if it started before the restructuring was authorized by the court. Once the authorization was given and the auction has not started, the auction shall be refrained from.

In a discharge of natural person by bankruptcy the position of a secured creditor is stronger. A secured creditor is entitled to choose whether or not he will file the debt to the procedure and whether such asset will actually become a part of discharge estate. If the secured creditor does not file the secured debt, such debt will not be influenced by the discharge procedure at all and its enforcement may start or continue without interruption. If the secured creditor decides to file his secured debt in a discharge procedure, in general the auction, if initiated by the secured creditor, will be discontinued. However, the secured creditor may later decide to enforce (via voluntary auction or otherwise) the collateral on his own and not within the discharge procedure. Also, there are specific rules on cases where there is more than one secured creditor, where only some of them filed their claims or where the value of the asset is higher than the secured claim(s).

The discharge of natural person by repayment plan does not influence the enforcement of the collateral except for one (but important) situation, namely a protection of debtor´s residence. If such residence is to be sold via a voluntary auction, the debtor has right to ask the auctioneer for a postponement of the auction once the stay of claims had been granted. Such postponement shall last for 6 months.

Slovenia

Source of information: SSM report, EBRD, Deloitte

Scope (contractual parties of the loan)

All contractual parties are eligible.

Categories of assets used as collateral

Immovable and movable assets.

Scope (type of security rights)

Mortgages on immovable assets, liens on movable assets and rights

Spain

Source of information: expert group

Scope (contractual parties of the loan)

All contractual parties are eligible (except for special security rights limited to corporates, such as floating charges) to agree contractually on an extrajudicial enforcement procedure.

Categories of assets used as collateral

Immovable and movable assets.

Scope (type of security rights)

Mortgages and pledges.

Existence of private sale, auction and appropriation methods

Extrajudicial notary auction is the only method available, and uses an online auction. Appropriation and private sale prohibited.

Procedural steps

Mandatory notification period, as agreed by contract or, by default, 10 days. Thereafter, a certificate issued by the creditor setting out the amounts claimed constitutes sufficient evidence of a claim, and includes interest, costs and expenses, fees and any other amounts accrued or to be accrued until the date of enforcement. Notarial auctions take place in the official online portal, must be officially announced at least 24 hours in advance and last at least 20 days.

Any other relevant information

Appropriation by creditor authorised if no bidders in two attempted auctions, provided that the whole claim is written off. Creditor can participate in auction if other bidders present.

Average time and costs for out-of-court collateral enforcement

Under normal circumstances 2-3 months.

Sweden

Source of information: Thomson Reuters Practical Law, International Comparative Legal Guide

Scope (contractual parties of the loan)

No explicit limitation of contractual parties.

Categories of assets used as collateral

Movable assets.

Scope (type of security rights)

In general, possessory pledge is required for tangible movable assets. Non-possessory or registered pledge is possible for some tangible movable assets (e.g. aircraft and ships), financial assets (dematerialised shares, receivables), and intangible assets (intellectual property).

Mortgages and floating charges require an enforcement title (e.g. judgment, arbitrage award) and are enforced through the Swedish enforcement body. They are subject to a stamp duty at creation of respectively 2% and 1% of face value.

Existence of private sale, auction and appropriation methods

The pledge agreement can freely define the enforcement method, generally either a public or private sale.

Procedural steps

Perfection of a pledge is specific for each asset type.

Any other relevant information

Creditor has the obligation of a duty of care in enforcement, and must look after the interest of the pledgor.

Bankruptcy suspends any individual enforcement action, except in the case of a possessory pledge which can be enforced through a public auction.

The United Kingdom

Source of information: Ministry of Justice response

Scope (contractual parties of the loan)

All contractual parties are eligible.

Categories of assets used as collateral

All types of assets can be subject to extrajudicial enforcement.

Scope (type of security rights)

Legal mortgages, equitable mortgages, charges, possessory pledges.

Existence of private sale, auction and appropriation methods

Extrajudicial appropriation possible for mortgages and charges, provided that the security contract stipulates this right or is made by deed, and the mortgagor/chargor voluntarily surrenders possession. Power of sale is available for mortgages, charges and pledges, provided that the security contract stipulates this right or is made by deed.

Appointment of receiver is a commonly used extrajudicial method available for legal mortgages and fixed charges, provided that the security contract stipulates this method. Secured creditors holding a floating charge over substantially all of the debtor's assets can appoint an administrator without court intervention, which is also a common enforcement method.

Procedural steps

The loan agreement can freely define events of default, which lead to the acceleration of the repayment obligation. The security defines the event that enables enforcement of the security. Different notification rules on enforcement apply to the various methods.

<u>Any other relevant information</u>

Security provider has several possibilities of appeal against enforcement, by contesting the existence of debt, the fact that it was due, by questioning the perfection of the security, or by contesting the documentation and notice requirements.

Mortgagee in possession is exposed to third party liabilities (e.g. environmental liabilities, other duties).

Individual enforcement by secured creditors is suspended automatically in administration and in compulsory liquidation.

<u>Average time and costs for out-of-court collateral enforcement (if available)</u>

Appropriation can be effective in a couple of days, if there is voluntary surrender by the chargor, but can last between 2 to 9 months if court intervention is needed.

Annex 6 – Impacts of the policy options – detailed description

Option 1 – Pros and cons

Pros:

- Promoting existing international harmonisation initiatives of extrajudicial collateral enforcement procedures, or national procedures/features of enforcement mechanisms which work well through a soft law approach. Member States could be made aware of the benefits that having such systems in place would bring benefits both domestically and on a cross-border basis. and would decide to implement the best practices in their systems

- Could incentivise Member States to implement those recommendations. A non-binding instrument would leave the highest degree of discretion to Member States as regards the ways in which they could implement the recommendations hence minimising the implementation cost. This also avoids possible disruptions of national regimes that work well.

- Administrative costs for public authorities might decrease, given that the cost of out-of-court enforcement procedure would be undertaken by private parties, secured creditors and companies/entrepreneurs. The secured creditor would have to advance the cost of the procedure but the final cost would be undertaken by the company/entrepreneur in default, which is similar to the pre-insolvency and insolvency procedure. This means that the intervention of any public authority in the enforcement process, such as notary or bailiff, would be at the expense of the parties.

Cons:

- Given the non-binding nature of the recommendation, the highest risk is that Member States choose to ignore it. Member States with no system in place could choose to stay without. Member States with inefficient systems could choose not to change them.

- Considering that option 1 is based on voluntary harmonisation, even if Member States would choose to adjust their national framework by following the recommendations which would be set at EU level, there is a high risk that the implementation of those recommendations would not fully achieve the policy objectives. For example, where Member States would introduce changes to their legal framework, they might only do so by taking into account the national perspective. As a result, this could lead to heterogeneity of approaches which will continue to inhibit cross-border collateral enforcement and lending, and will continue exposing banks to a higher risk of accumulation of NPLs. The absence of a consistent and predictable EU-wide framework would continue to create a considerable layer of uncertainty and increase costs of enforcement cross-border. Banks would not benefit from a level-playing field as regards their ability to enforce collateral out-of-court.

Option 1 – Stakeholders impacts

Corporate (including entrepreneurs and SME) as borrowers

Positive direct[103] impact:

- Borrowing costs for business borrowers are expected to decrease as banks with an effective, expedite way to enforce their collateral can expect both a lower probability of default (since debtor's moral hazard is reduced) and a lower loss given default (as the collateral value will not diminish due to lengthy court procedures). With reduced risks, banks will adjust their pricing accordingly (i.e. downwards). Moreover thanks to the reduction of risks explained above (especially the lower loss given default) more projects which were not able to get financing previously would now become financeable again. As a result secured lending and overall the supply of finance is expected to increase. The last two points are especially true for SMEs rather than corporates as the latter can also finance themselves through the capital markets (i.e. issue bonds) whereas the former are heavily reliant on bank financing. However, given the uncertainties related to the take up of recommendation the benefits are expected to be *quite marginal*: a quantification work carried out by the Commission services (see annex 4) indeed shows that the long term annual savings for borrowers for option 1 are estimated between EUR123M and EUR219M. This means a reduction of borrowing costs estimated between 2 and 4 basis points.

Negative direct impacts[104]:

- Companies in financial difficulties and with an unsustainable business model will see their collateral enforced and sold/taken away quicker. The company might cease to operate in case of enforcement of the main productive assets which will however be recycled for a more productive use (hence resulting in a net societal/macroeconomic gain).

Secured creditors including investors

Positive direct[105] impacts:

- The formalities, time delays and costs typically associated with a court enforcement process can be reduced for banks operating in those Member States following the recommendation and hence being able to enforce the collateral more quickly and cheaply out of court. This is expected to increase the recovery rates on defaulted secured loans. Given the uncertainties related to the take up of recommendation, the benefits are expected to be *quite marginal*: a quantification work carried out by the Commission services (see annex 4) indeed shows that the extra amount recovered by banks in a simulated future NPL crises is estimated at 0.6% compared to the baseline

[103] A positive indirect impact would be that, given that banks would be equipped with an effective and speedy tool to enforce the collateral, this could work as default deterrent for the borrowers.

[104] A negative indirect impact would be that although the mechanism is voluntary and will have to be agreed upon by both parties in the loan contract, the negotiation power of businesses especially SME to include or not such mechanism will be limited. This increases the need for safeguards for debtor (see social impacts).

[105] A positive direct impact would be that the probability of default might decrease for secured loans given that debtor moral hazard will be reduced: as debtors might be well aware that the collateral will be easily and quickly enforced they will be more incentivised to pay their loans in a timely manner. However, even if the borrower is willing to pay, its actual ability to do so depends also on external factors.

(with average recovery rate expected to increase to 70% from the current estimated level of 68%). The extra recovered amount by banks is estimated at EUR2billion.

- The recommendation (if followed up) might provide more transparency and certainty to secured creditors as regards the enforcement process relating to defaulted loans across the EU. This should contribute to reducing (*albeit marginally*) the build-up of NPLs and thus would *somewhat* encourage lending especially domestically as the low degree of harmonization expected would still not facilitate more cross-border lending (as legal and research costs that banks and secured creditors incurred when enforcing collateral cross-border would not be reduced).

- [Third party investors] The increased recovery rates will improve the conditions for banks to tackle NPLs directly or to sell (at higher price) to third party NPL investors. This would reduce *(albeit marginally)* the bid/ask spreads explained in the problem definition from the demand (i.e. divesting banks) side especially domestically. Moreover, the low degree of harmonization achieved with a recommendation would only marginally facilitate the creation of pan-European NPLs investors which would not be able to fully reap the benefits of the Single Market. The bid/ask spreads explained in the problem definition from the supply (i.e. NPLs companies) side might be reduced *(albeit marginally).*

Negative impacts[106]:

- Increased reputational risk for banks which arises from the enforcement of collateral through an out-of-court mechanism.

<u>Other commercial creditors (unsecured creditors, junior creditors, suppliers, etc..)</u>

Positive indirect impacts:

- The underlying assumption is that collateral disposal price will be maximised through an expedited out-of-court mechanism governed by clear rules. This should in principle allow for a better satisfaction of secured creditors than it is the case today by enabling those creditors to recover full value (hence the increased recovery rates as explained above). By maximising value recovery, it is expected that this would also contribute indirectly to increasing the estate of the borrower in cases where the borrower would be subject to a restructuring or insolvency proceeding after the out-of-court mechanism is used. However, this would depend on a case by case basis, on the amount which is recovered through the use of the out-of-court mechanism.

Negative impacts:

[106] Another negative but not significant impact for secured creditors is that they will have to bear the costs related to out-of-court collateral enforcement in a first stage. However those costs would be recouped from the borrower once the collateral is enforced. The costs associated with out-of-court enforcement would however not be significant for banks because they would mainly consist in costs related to the notification of the borrower in case of default, possibly a second notification on the use of the out-of-court mechanism (if a second notification is needed; this depends on national legislation), and the fees that need to be paid to either an authority which would be involved in the enforcement process, such as a notary or a bailiff, or costs charged by an expert, in case a valuation of the collateral is needed (in case of enforcement through the appropriation mechanism).

- If the out-of-court mechanism is "overused" (not only on companies with an unsustainable business but also on companies with a sustainable business model), this might prevent finding a deal for saving the business. Also this could be negative for the suppliers of that corporate borrower which are likely to lose their commercial relationship with that borrower earlier than this would have happened, should the out-of-court enforcement mechanism not have been used. However triggering an out-of-court procedure will be on a case by case as it could also be that the banks prefer in certain occasions the business to be restructured rather than being put into insolvency as a restructured business has the potential of benefiting of banks loans in the future.

Member states (competent authorities and public creditors):

Positive direct impacts:

- The positive impacts for business and secured creditors alike as described in details above would increase the general economic sentiment in a given Member State.
- More cases will be dealt out-of-court and this would free up courts resources and capacities to deal with other types, more complex cases (i.e. insolvency and restructuring cases)[107]. Moreover as the costs associated with the out-of-court procedures would mainly be borne by banks and companies, and not by the taxpayers as it is the case today for judicial enforcements of collateral, this could bring some cost savings for the public administration.
- Equipping banks with better tools with dealing with their non-performing loans would bring about financial stability benefits. If the build-up of future NPLs is avoided or contained, supervisors would have more time and resources to dedicate to other supervisory activities. The recommendation would not change the ranking of creditors in an insolvency proceeding and as such potential super-seniority of public debt under national laws would be unaffected by it.

Negative impacts:

- Implementation costs incurred by public authorities linked to change of the law following the recommendation. However these are expected to be quite minimal.

Option 2 – pros and cons

Pros:

- The harmonisation of key features of an extrajudicial enforcement procedure would ensure expedited and effective extrajudicial enforcement procedures across the EU. This could be done by building on well-functioning systems. A common set of key principles and rules would contribute to ensuring a level-playing field for banks across the EU and increase certainty for the banks as regards their ability to recover value from collateral in a similar way in all Member States. By reducing the number of court cases related to collateral enforcement, this option should decrease the cost of enforcing collateral by avoiding fees related to often complex and lengthy judicial

[107] The possible decrease of court cases would also depend on the number of appeals against the out-of-court enforcement procedures.

procedures. In a cross-border context, this option would provide more legal certainty and would decrease legal and research costs.

- This option would provide flexibility to Member States as regards the implementation of the accelerated enforcement procedure into national frameworks while establishing a common set of rules. For example, the choice of security rights in relation to which the AECE could be used, publicity requirements, detailed provision as regards the enforcement procedure, etc. would be left to Member States' discretion. This should minimise the implementation costs required by the directive.

- It would minimise impact on Member States' private and public laws. This is in particular important for Member States which have already established such procedures. For example, it would not impact the ranking of creditors because this option would not lead to establishing a new security right (as opposed to option 3), but would only provide for an enforcement mechanism which could be used in relation to existing security rights in the Member State.

- Administrative costs for public authorities might decrease, given that the cost of out-of-court enforcement procedure would be undertaken by private parties, secured creditors and companies/entrepreneurs. The secured creditor would have to advance the cost of the procedure but the final cost would be undertaken by the company/entrepreneur in default, which is similar to the pre-insolvency and insolvency procedure. This means that the intervention of any public authority in the enforcement process, such as notary or bailiff, would be at the expense of the parties.

Cons:

- Member States may implement the rules in divergent ways, given the discretion which is left to them on a number of areas[108]. The level of divergence is however lower compared to option 1.

- This option would not create the highest level of effectiveness and legal certainty as regards out-of-court collateral enforcement procedures, as opposed to option 3 which would consist in full harmonisation. Nevertheless, the great variety of features of Member States' private and public laws require a certain level of flexibility for Member States to implement an EU framework on out-of-court enforcement to enable them to apply it in a suitable fashion. A minimum harmonisation framework would enable Member States to use the most appropriate means to make AECE work in their national systems. In particular, given the strong interlinks between collateral enforcement and pre-insolvency and insolvency rules, a margin of discretion is needed so that AECE fits with those national systems. The proposal on preventative restructuring and second chance frameworks which the Commission has presented in November 2016 is a minimum harmonisation directive. The interlinks of preventative restructuring and second chance with national private laws and insolvency systems has been a key consideration in envisaging a minimum harmonisation directive which would allow Member States to decide upon the specific means by which that proposal would be implemented to make it compatible with national frameworks.

Option 2 – stakeholders' impacts

Corporate (including entrepreneurs and SME) as borrowers

Positive direct[109] impact:

- Borrowing costs for business borrowers are expected to decrease as banks with AECE (i.e. an effective, expedite way to enforce their collateral) can expect both a lower probability of default (since debtor's moral hazard is reduced) and a lower loss given default (as the collateral value will not diminish due to lengthy court procedures). With reduced risks, banks will adjust their pricing accordingly (i.e. downwards). Moreover thanks to the reduction of risks explained above (especially the lower loss given default) more projects which were not able to get financing previously would now become financeable again. As a result secured lending and overall the supply of finance is expected to increase also on a cross-border level (thanks to higher level of harmonization achieved by the directive – see also below in secured creditors section). The last two points are especially true for SMEs rather than corporates as the latter can also finance themselves through the capital markets (i.e. issue bonds) whereas the former are heavily reliant on bank financing. Given the level of harmonisation expected to be achieved by the directive the benefits are *somewhat significant*: a quantification work carried out by the Commission services (see annex 4) indeed shows that the long term annual savings for borrowers for option 2 are estimated between EUR562M and EUR1000M. In terms of the reduction of borrowing rates, this is estimated on average between 10 and 18 basis points.

Negative direct impacts[110]:

- Companies in financial difficulties and with an unsustainable business model will see their collateral enforced and sold/taken away quicker. The company might cease to operate in case of enforcement of the main productive assets which will however be recycled for a more productive use (hence resulting in a net societal/macroeconomic gain).

Secured creditors including investors

Positive direct[111] impacts:

- The formalities, time delays and costs typically associated with a court enforcement process can be reduced for banks across the EU with the implementation of the directive which will then to be able to enforce the collateral more quickly and cheaply out of court across the EU in a more systematic way. This is expected to increase the recovery rates on defaulted secured loans. Given the level of harmonisation expected

[109] A positive indirect impact would be that, given that banks would be equipped with an effective and speedy tool to enforce the collateral, this could work as default deterrent for the borrowers.

[110] A negative indirect impact would be that although the mechanism is voluntary and will have to be agreed upon by both parties in the loan contract, the negotiation power of businesses especially SME to include or not such mechanism will be limited. This increases the need for safeguards for debtor (see social impacts).

[111] A positive direct impact would be that the probability of default might decrease for secured loans given that debtor moral hazard will be reduced: as debtors might be well aware that the collateral will be easily and quickly enforced they will be more incentivised to pay their loans in a timely manner. However, even if the borrower is willing to pay, its actual ability to do so depends also on external factors.

to be achieved by the directive, the benefits are *somewhat significant*: a quantification work carried out by the Commission services (see annex 4) indeed shows that the extra amount recovered by banks in a simulated future NPL crises is estimated at 2.3% compared to the baseline (with average recovery rate expected to increase to 78% from the current estimated level of 68%). The extra recovered amount by banks is estimated at EUR8.1billion.

- A harmonised legal framework on out-of-court collateral enforcement should also encourage banks to make available more credit, including possibly cross-border. Banks will only lend cross-border if they feel comfortable to be able to recover value in a reasonable time span from collateral taken in the other Member State. While bank financing is hard to come by in some Member States, in others banks would be interested in financing innovative projects. Facilitating cross-border lending could help tackle shortage of bank financing for SMEs in some Member States. If efficient out-of-court recovery procedures are in place in one Member State and render domestic lending cheaper, businesses from other Member States which have the chance will borrow from banks in that Member State by posing collateral under the "efficient" system, e.g. a subsidiary's assets, and business will thus move towards Member States with an efficient system whereas it would be preferable if banks in all Member States could compete on equal footing. The harmonisation achieved by the directive is expected to provide more transparency and certainty to secured creditors as regards the enforcement process relating to defaulted loans across the EU. This should contribute to reducing the build-up of NPLs and thus would encourage lending both domestically and on a cross-border lending (as legal and research costs that banks and secured creditors incurred when enforcing collateral cross-border would be reduced).

- [Third party investors] The increased recovery rates will improve the conditions for banks to tackle NPLs directly or to sell (at higher price) to third party NPL investors. This would reduce*)* the bid/ask spreads explained in the problem definition from the demand (i.e. divesting banks) side both domestically and on a cross-border basis. Moreover, the harmonization achieved by the directive would facilitate the creation of pan-European NPLs investors which would be able to reap the benefits of the Single Market. The bid/ask spreads explained in the problem definition from the supply (i.e. NPLs companies) side might be reduced.

Negative impacts[112]:

- Increased reputational risk for banks which arises from the enforcement of collateral through an out-of-court mechanism

<u>Other commercial creditors (unsecured creditors, junior creditors, suppliers, etc.)</u>

[112] Another negative but not significant impact for secured creditors is that they will have to bear the costs related to out-of-court collateral enforcement in a first stage. However those costs would be recouped from the borrower once the collateral is enforced. The costs associated with out-of-court enforcement would however not be significant for banks because they would mainly consist in costs related to the notification of the borrower in case of default, possibly a second notification on the use of the out-of-court mechanism (if a second notification is needed; this depends on national legislation), and the fees that need to be paid to either an authority which would be involved in the enforcement process, such as a notary or a bailiff, or costs charged by an expert, in case a valuation of the collateral is needed (in case of enforcement through the appropriation mechanism).

Positive indirect impacts:

- The underlying assumption is that collateral disposal price will be maximised through an expedited out-of-court mechanism governed by clear rules. This should in principle allow for a better satisfaction of secured creditors than it is the case today by enabling those creditors to recover full value (hence the increased recovery rates as explained above). By maximising value recovery, it is expected that this would also contribute indirectly to increasing the estate of the borrower in cases where the borrower would be subject to a restructuring or insolvency proceeding after the out-of-court mechanism is used. However, this would depend on a case by case basis, on the amount which is recovered through the use of the out-of-court mechanism and the type of creditor concerned.

Negative impacts:

- If the out-of-court mechanism is "overused" (not only on companies with an unsustainable business but also on companies with a sustainable business model), this might prevent finding a deal for saving the business. Also this could be negative for the suppliers of that corporate borrower which are likely to lose their commercial relationship with that borrower earlier than this would have happened, should the out-of-court enforcement mechanism not have been used. However triggering an out-of-court procedure will be on a case by case as it could also be that the banks prefer in certain occasions the business to be restructured rather than being put into insolvency as a restructured business has the potential of benefiting of banks loans in the future.

<u>Member states (competent authorities and public creditors):</u>

Positive direct impacts:

- The positive impacts for business and secured creditors alike as described in details above would increase the general economic sentiment in a given Member State.
- More cases will be dealt out-of-court and this would free up courts resources and capacities to deal with other types, more complex cases (i.e. insolvency and restructuring cases)[113]. Moreover as the costs associated with the out-of-court procedures would mainly be borne by banks and companies, and not by the taxpayers as it is the case today for judicial enforcements of collateral, this could bring some cost savings for the public administration.
- Equipping banks with better tools with dealing with their non-performing loans would bring about financial stability benefits. If the build-up of future NPLs is avoided or contained, supervisors would have more time and resources to dedicate to other supervisory activities.
- A minimum harmonisation envisaged under this option would not change the ranking of creditors in an insolvency proceeding and as such potential super-seniority of public debt under national laws would be unaffected by it.

Negative impacts:

[113] The possible decrease of court cases would also depend on the number of appeals against the out-of-court enforcement procedures.

- Implementation costs incurred by public authorities linked to change of the law following the directive.

Option 2 – stakeholders' views

The banking industry is supportive of the establishment of an out-of-court enforcement procedure across the EU which would allow secured creditors (banks) to enforce collateral without judicial court intervention in case of borrower's default. The avoidance of the court involvement in the disposal of the collateral would help to avoid the accumulation of NPLs through better recoveries in shorter period of time (especially in jurisdictions with suboptimal in-court enforcement procedures). Some respondents also underlined that the threat of a possible collateral enforcement can in itself be persuasive and reduce moral hazard of debtor. In general banks do no automatically wish to enforce the collateral and they wish to keep the freedom of choosing to enforce the collateral or not (which will be assured by the voluntary nature of the mechanism). The banking industry expressed concerns as to: (i) the suspension of the mechanism during restructurings and insolvency proceedings arguing that this limitation would weaken the value of security and would discourage banks from supporting restructuring efforts for a debtor's potentially viable business; and (ii) a rule which would allow full discharge of the borrower[114]. On the scope there was a general consensus for the Commission's approach to exclude consumers and certain types of assets.

The investors and loan servicing companies expressed support. They argue that costs and time efficiencies derived from an out-of-court process can lead to better recoveries. They also stressed the importance of allowing for a transfer of this mechanism to investors to help the development of secondary markets for NPLs. Echoing the banking industry, they also expressed doubts as to the full effectiveness of this mechanism if it is switched off during insolvency and to the full discharge of the debtor which – it is argued – might discourage banks as the risk of a reduction in price of the collateral would be borne by the bank while an increase would only benefit the debtor. On the scope, they also agreed with the proposed scope given the need for special protection for the weakest party.

Government and public authorities agreed that improving the protection of secured creditors is instrumental in resolving and reducing NPLs. A greater convergence of secured loan enforcement (both judicial and extrajudicial) in the EU could benefit enterprises by facilitating credit. Fragmented legal frameworks and the inefficiencies in the national judicial systems represents vulnerability for bank stability (through the possibility of systemic crisis) having a negative impact on the capacity of financial institutions to provide lending. Some Member States expressed doubts that such an instrument can significantly accelerate the enforcement process in those Member States where procedures carried out by courts are already handled in a short period of time. One Member State argued that while out-of-court procedures can be beneficial, the solution to the NPL problem lies mainly on strengthening the judicial procedure across the EU.

[114] Banks argued that this could encourage borrowers to act irresponsibly and increase speculative behaviours especially when the recovered value from the sale of assets is lower than the value of the outstanding amount.

Two out of the four Member States which currently do not have out-of-court enforcement procedures for collateral (DK and MT) support the objectives of the Commission to introduce such mechanisms for loans granted to companies and entrepreneurs (with the exclusion of consumers and the primary residence of a corporate owner), but insist that out-of-court enforcement procedures should not interfere with the Commission's proposal on preventive restructuring and second chance, and with Member States' insolvency laws. They consider that an EU framework on an out-of-court instrument would provide further optionality to banks that wish to enforce loans to avoid accumulation of NPLs and may improve capital flows to the country as lenders would have pre-determined exit routes.

Government and public authorities also agree on the scope exclusions based on social equity grounds. Finally while recognizing the need of appropriate balance between legitimate interests of secured creditors in having their rights enforced without delay and the protection of the rights of debtors, they expressed doubts about the full discharge for the debtor as this could call into question the strengthening of the position of secured creditors as any subsequent (to the loan disbursement) decrease in value of the assets results in a unilateral burden for the creditor. One safeguard for debtors suggested by one Member States is to involve a third party responsible to oversight the process and assuring that the interests of both creditors and debtors are met.

Law firms also highlighted that an efficient, out-of-court enforcement process is essential for all security rights to ensure that there are effective and facilitate resolution of debts. The overall flexibility afforded by the provisions is then likely to lead to better recoveries. The formalities, time delays and costs typically associated with a court enforcement process are also not present, which enables the security to be enforced more quickly and cheaply. Further, any moral hazard on the part of the debtor caused by lengthy court enforcement processes is also avoided. They also mentioned that third-party loan servicers may be more willing to use an out-of-court option as they have less fear of reputational damage especially in jurisdictions where lenders view court enforcement as providing a layer of protection from liability vis-à-vis those borrowers who claim the proceeds should have been higher. Law firms see merit in EU action to establish a common enforcement procedure because this would provide banks with certainty in respect of process and timing to enforce security.

Consumer associations, NGOs and private individuals also agreed with limiting the scope of application on social equity ground.

Business associations did not respond to the public consultation but their views were heard in an ad-hoc meeting organised by the Commission services. Although there was not a formal official position since a consensus inside the members of their associations had not been reached at the time of the meeting, the representatives agreed in their personal capacity about the usefulness of the system arguing however that this is higher in those Member States without such a system or with an inefficient system (the Spanish mechanism was mentioned) especially in those Member States with current high level of non-performing loans. The main benefit mentioned was a reduction in risks and hence a decrease in lending rates especially for SMEs arguing that the interest rate differential for SME borrowing costs in the EU (and especially the Eurozone) is partially explained by the differences in the level of (in)efficiencies in recovery value / enforcement procedures among Member States. The need for safeguards for debtors would inevitably be priced in by the lenders.

The expert group called on the Commission to avoid creating a new security right accompanied by an out-of-court enforcement mechanism. According to the experts, doing so would interfere too much with national legal systems and would be extremely complex insofar as very technical provisions are closely linked to national rules on security law, transfer of ownership, publicity requirements, and ranking of creditors in insolvency. The expert group sees merit and is supportive of an EU measure which would establish a common framework for out-of-court enforcement of collateral. A common framework on out-of-court collateral enforcement would increase legal certainty and predictability for banks as regards their ability to enforce collateral swiftly. This would allow banks to recover more value in case of borrower's default and would therefore put assets to a better use and create incentives for banks to give more loans to companies. The expert group insisted on the need for a swift and transparent procedure, given that existing mechanisms are often not used in practice because they do not ensure an expedited process to allow for value recovery (i.e. process leading to selling assets much below market value, which is neither satisfactory for banks, nor for the borrowers).

Option 3 – pros and cons

Pros:

- This option would make available a new security right which could be used by banks to secure loans, upon voluntary agreement with companies and entrepreneurs, together with a fully harmonised extrajudicial enforcement mechanism. Because the new security right would be regulated at EU level and the enforcement procedure fully harmonised, banks in all Member States would benefit in a uniform way from the possibility to recover value from secured loans, should they choose the ALS. This would increase legal certainty and predictability. From a single market perspective, banks would no longer have to invest time and bear costs related to assessing the way in which they can recover value on a cross-border basis. Option 3 would lead to a decrease in the cost of cross-border transactions and would facilitate cross-border lending to companies and entrepreneurs to the greatest extent.

- The full harmonisation of the extrajudicial enforcement mechanisms for secured loans in the Member States would ensure that the same expedited and effective procedure is available across the EU, it is hence expected there would be somewhat significant benefits both for banks (in terms of reduction in recovery rates) and business borrowers (in terms of reduction in interest rates).

- The out-of-court enforcement is easier in case ALS given the legal certainty it offers as regards the ownership of the collateral at the moment of borrowers' default. As matter of fact because the creditor is the owner from the signing of the loan agreement, the creditor can take actions to take swiflty the possession of the collateral.

Cons:

- While Option 3 would bring the most in terms of harmonisation and a true uniform out-of-court enforcement procedure, it would have a major impact on Member States' legal frameworks. The creation of new independent EU collateral in addition to the ones existing at national level would require the integration of such a new security right into Member States' legal systems. That is because it would require Member States to adjust and align numerus areas of their national legal systems (*e.g.* property law, private and public law, registration rules, insolvency laws etc.), which are largely different across EU, reflecting their respective legal traditions, political choices and economic structures.

- The establishment of a new security right would raise the politically sensitive issue of hierarchy of creditors in pre-insolvency and insolvency procedures. It might be difficult to accept by Member States, because of numerous changes which they would have to make to adapt their legal frameworks to a new type of security. Member States would also need to ensure that current formalities and publicity requirements for existing security rights are modified to take into account the establishment of an EU register for the publication of ALS.

  - The establishment of a new security right might create complexity and legal uncertainty in the Member States which already have a security right with similar features. For example, where a similar right exists in a Member State, it might become difficult for banks and corporates to decide which security to choose between the one which currently exist and the one which might be established through EU legislation.

  - The establishment of a new security right would lead to significant compliance costs, especially as regards the implementation of a new security right, the relevant formalities/publicity requirements, training of the legal professions in relation to the application of a new security right, and for the implementation of a fully harmonised extrajudicial enforcement procedure. Important compliance cost would be expected by the industry to adapt contracts and practice to the use of a new security right.

Option 3 – stakeholders' impact

<u>Corporate (including entrepreneurs and SME) as borrowers</u>

Positive direct[115] impact:

- Borrowing costs for business borrowers are expected to decrease as banks with ALS (i.e. an EU security right with an effective, expedite way to enforce out of court) can expect both a lower probability of default (since debtor's moral hazard is reduced) and a lower loss given default (as the collateral value will not diminish due to lengthy court procedures). With reduced risks, banks will adjust their pricing accordingly (i.e. downwards). Moreover thanks to the reduction of risks explained above (especially the lower loss given default) more projects which were not able to get financing previously would now become financeable again. As a result secured lending and overall the supply of finance is expected to increase also on a cross-border level (thanks to highest level of harmonization achieved by the regulation – see also

[115] A positive indirect impact would be that, given that banks would be equipped with an effective and speedy tool to enforce the collateral, this could work as default deterrent for the borrowers.

explanations below in secured creditors section). The last two points are especially true for SMEs rather than corporates as the latter can also finance themselves through the capital markets (i.e. issue bonds) whereas the former are heavily reliant on bank financing. Given the level of harmonisation expected to be achieved by the regulation the benefits are *somewhat significant*: a quantification work carried out by the Commission services (see annex 4) indeed shows that the long term annual savings for borrowers for option 3 are estimated between EUR634M and EUR1129M. In terms of reduction of borrowing costs this is estimated between 11 and 19 basis points[116].

Negative direct impacts[117]:

- Companies in financial difficulties and with an unsustainable business model will see their collateral enforced and sold/taken away quicker. The company might cease to operate in case of enforcement of the main productive assets which will however be recycled for a more productive use (hence resulting in a net societal/macroeconomic gain).

<u>Secured creditors including investors</u>

Positive direct[118] impacts:

- A fully harmonised legal framework around a new security right and an out-of-court collateral enforcement would provide the highest transparency and certainty to secured creditors as regards the enforcement process relating to defaulted loans across the EU. The formalities, time delays and costs typically associated with a court enforcement process can be reduced for banks across the EU hence being able to enforce the collateral more quickly and cheaply out of court. This is expected to increase the recovery rates on defaulted secured loans. Given the high level of harmonisation expected to be achieved by the regulation, the benefits are *somewhat significant*: a quantification work carried out by the Commission services (see annex 4) indeed shows that the extra amount recovered by banks in a simulated future NPL crises is estimated at 2.6% compared to the baseline (with average recovery rate expected to increase to 80% from the current estimated level of 68%). The extra recovered amount by banks is estimated at up to EUR 9 billion.

- From the perspective of the single market, this option should create the highest incentives for cross-border enforcement, cross-border lending and the development of secondary markets for NPLs because it would eliminate the most the uncertainty and costs related to assessing the business environment and to enforcing security rights cross-border. While being very "intrusive", a harmonised approach to this ALS-type, adopted under the form of an EU Regulation could increase the willingness of banks

[116] This is net of a possible increase in basis points that reflect the increased costs of the implementation of a new security right

[117] A negative indirect impact would be that although the mechanism is voluntary and will have to be agreed upon by both parties in the loan contract, the negotiation power of businesses especially SME to accept the ALS as security right (and hence to include or not out-of-court mechanism) will be limited. This increases the need for safeguards for debtor (see social impacts).

[118] A positive direct impact would be that the probability of default might decrease for secured loans given that debtor moral hazard will be reduced: as debtors might be well aware that the collateral will be easily and quickly enforced they will be more incentivised to pay their loans in a timely manner. However, even if the borrower is willing to pay, its actual ability to do so depends also on external factors.

to lend to businesses on a cross-border basis. In situations the ALS proceedings need to be instigated, the bank could trigger the loan security in contracts written under the law of its country to take possession of collateral located in another Member State. The possibility to enforce these rights cross-border would be therefore relatively clear and certain.

- [Third party investors] The increased recovery rates will improve the conditions for banks to tackle NPLs directly or to sell (at higher price) to third party NPL investors. This would reduce the bid/ask spreads explained in the problem definition from the demand (i.e. divesting banks) side both domestically and on a cross-border basis. Moreover, the highest harmonization achieved by the regulation would facilitate the creation of pan-European NPLs investors which would be able to reap the benefits of the Single Market. The bid/ask spreads explained in the problem definition from the supply (i.e. NPLs companies) side might be reduced.

Negative impacts[119]:

- Increased reputational risk for banks which arises from the enforcement of collateral through an out-of-court mechanism
- In case of appropriation, the banks will have to internalise other risks (environmental and other liabilities) and also consolidate the assets on their balance which will eat away somewhat their capital and lending capacity

<u>Other commercial creditors (unsecured creditors, junior creditors, suppliers, etc..)</u>

Positive indirect impacts:

- The underlying assumption is that collateral disposal price will be maximised through the ALS. This should in principle allow for a better satisfaction of secured creditors than it is the case today by enabling those creditors to recover full value (hence the increased recovery rates as explained above). By maximising value recovery, it is expected that this would also contribute indirectly increasing the estate of the borrower in cases where the borrower would be subject to a restructuring or insolvency proceeding after the out-of-court mechanism is used. However, this would depend on a case by case basis, on the amount which is recovered through the use of the out-of-court mechanism.

Negative impacts:

- If the ALS is "overused" (not only on companies with an unsustainable business but also on companies with a sustainable business model), this might prevent finding a deal for saving the business. Also this could be negative for the suppliers of that corporate borrower which are likely to lose their commercial relationship with that

[119] Another negative but not significant impact for secured creditors is that they will have to bear the costs related to out-of-court collateral enforcement in a first stage. However those costs would be recouped from the borrower once the collateral is enforced. The costs associated with out-of-court enforcement would however not be significant for banks because they would mainly consist in costs related to the notification of the borrower in case of default, possibly a second notification on the use of the out-of-court mechanism (if a second notification is needed; this depends on national legislation), and the fees that need to be paid to either an authority which would be involved in the enforcement process, such as a notary or a bailiff, or costs charged by an expert, in case a valuation of the collateral is needed (in case of enforcement through the appropriation mechanism).

borrower earlier than this would have happened, should the out-of-court enforcement mechanism not have been used. However triggering an out-of-court procedure will be on a case by case as it could also be that the banks prefer in certain occasions the business to be restructured rather than being put into insolvency as a restructured business has the potential of benefiting of banks loans in the future.

<u>Member states (competent authorities and public creditors):</u>

Positive direct impacts:

- The positive impacts for business and secured creditors alike as described in details above would increase the general economic sentiment in a given Member State.
- More cases will be dealt out-of-court and this would free up courts resources and capacities to deal with other types, more complex cases (i.e. insolvency and restructuring cases)[120]. Moreover as the costs associated with the out-of-court procedures would mainly be borne by banks and companies, and not by the taxpayers as it is the case today for judicial enforcements of collateral, this could bring some cost savings for the public administration.
- Equipping banks with better tools with dealing with their non-performing loans would bring about financial stability benefits. If the build-up of future NPLs is avoided or contained, supervisors would have more time and resources to dedicate to other supervisory activities.

Negative impacts:

- Implementation costs incurred by public authorities linked to change of the law following the recommendation are significant.

- Potential significant compliance costs, especially as regards the implementation of a new security right, the relevant formalities/publicity requirements, training of the legal professions in relation to the application of a new security right, and for the implementation of a fully harmonised extrajudicial enforcement procedure. The establishment of an EU register for the publication of the secured loans which could be enforced out-of-court would also imply costs related to the necessary infrastructure and transmission of information to that register.

- The creation of a new security right will entail extra costs. These will depend on the levels set by MS and is difficult to foreseen at EU level. However the best approximation is given by the costs for existing security rights.

Box on cost of carrying out publicity formalities

As documented in a recent report[121], countries have substantially different approaches when it comes to registration of security rights or filling in with a public authority both of which are referred to as "publicity formalities". For instance, in Finland or in the Netherlands publicity formalities are free of charge or the applicable costs are immaterial. In the majority of cases, however, taking security triggers significant costs, often related to the value of the secured

[120] The possible decrease of court cases would also depend on the number of appeals against the out-of-court enforcement procedures.

[121] Guide to Cross-Border Secured Transactions – Deloitte – December 2013

liabilities or of the asset subject to security. Such costs generally differ based on the object of the security (see Table 18 below):

- Mortgages over real estate assets usually trigger notary fees, mortgage fees or taxes and registration fees with the land registries;
- Security over non-real estate assets usually triggers costs related to registration which generally is significantly lower than the cost for taking security over real estate

The duration of carrying out public formalities also differs among jurisdictions with e.g. one day needed in Bulgaria for real estate assets and between three and four months for Poland. Also publicity formalities can have different enforceability effects: for example in the case of Romania and Belgium even though the validity of the security is not affected by the lack of/delay in performing the publicity formalities until such formalities are carried out the security is not enforceable towards third party.

Table 18 – Cost of carrying out publicity formalities

Publicity Costs	Real Estate Assets	Non Real estate assets
Belgium	• registration fee 1% inscription fee of the amount of the mortgage • inscription fee 0.30% of the amount of the mortgage	Pledge over business/floating charge: 0.5% on the amount of the floating charge
Bulgaria	• notary fee: maximum EUR 3,000 • land registry fee: 0.01% of the value of the secured amount	Up to EUR 100
Croatia	notary fee: from 0.5% to 1% of the value of the asset or of the value of the secured claim (whichever is lower)	Up to EUR 100
Czech Republic	varies from 1% to 0.05% depending on the value of the mortgage	Up to EUR 100
England and Wales	between GBP 0 and EUR 300	Up to EUR 100
Finland	not material, not related to value of the transaction or of the secured amount	n.a.
France	• real estate security tax: 0.05% of the secured amount • land registration tax: 0.715% of the registered amount	Up to EUR 150
Hungary	• notary fees: depend on the value of the secured claim and capped at EUR 660,000; for mortgages set up by credit institutions the applicable fees are 25% of the regular fees • land registry fee: EUR 40 per real estate	Up to EUR 150
Italy	notary fee: approx. 2% of the value of the secured amount, but the notary may reduce at its discretion	n.a.
Latvia	• land book fee: 0.1% of the value of the obligation but capped at EUR 1425 • notary fee: 71 EUR	Less than EUR 50
Lithuania	• less than EUR 200	n.a.
Luxembourg	• registration fee 0.24% of the value of the secured debt • mortgage tax of 0.05% for the first registration and every renewal • notary fee also applies and depends on the value of the secured amount	Registration fee 0.24% of the value of the secured debt and mortgage tax of 0.05% for the first registration and every renewal
Poland	• notary fee: up to approx. EUR 1200 and civil law transaction tax of 0.1% of the amount secured	Less than EUR 50
Romania	• notary fee: 0.07% of the value of the secured amount • land registry fee: 0.1% of the value of the secured amount	Up to EUR 100
Slovenia	• less than EUR 150	Up to EUR 100
Spain	• notary fee: percentage of the secured amount; fee agreed between the parties and the notary for secured amounts higher than EUR 6 million • registry fee: 0.02% of the secured liability • stamp duty: 0.5% to 1.5% of the secured liability	n.a.
The Netherlands	• less than EUR 150 • notary fee: 0.01% of the value of the mortgage	Free of charge

Source: Guide to Cross-Border Secured Transactions – Deloitte – December 2013

Option 3 – stakeholders' views

The banking industry sees the potential benefits of an ALS such as increase in access to capital, increased stability of the financial sector and more cross-border lending. The benefits would be especially visible if the instrument remains enforceable in insolvency/pre-insolvency procedures although it is recognised that such an advantage for secured creditors cannot be integrated into national insolvency regimes without significant disruptions. However because of inherent risks associated especially mortgaged real estate, all respondents from the banking industry (barring one) said that it would be preferable that banks be granted authority to sell instead of becoming owner of the assets in the case of an out-of-court enforcement procedure under the form of appropriation. In the case of appropriation, if a bank would repossess the asset granted as collateral by the borrower, the bank would have to consolidate the repossessed assets on its balance sheets. Banks consider that such a process takes away some of the lending firepower. Therefore, banks call for being allowed to sell the assets which they would repossess through the appropriation procedure. Private sales or auctions (public sales) were mentioned as alternative methods to satisfy the lenders while keeping the assets off the balance sheet. Moreover the banking industry recognizes that the ALS as a contractual right would have to be implemented through a tailored approach in each Member State in order to accommodate the existing legal framework of private laws which are highly divergent within the EU. As for option 2, there is no support for debtor's full discharge. Banks call for efficient judicial systems which would exercise judicial control and protect the rights of borrowers.

For investors and loan servicing companies it is important that the ALS be transferrable to the investors. Otherwise this would create an obstacle for the development of secondary markets for NPLs. In general the views of investors and loan servicing companies are aligned with those of banks on i) scope; ii) the need to provide the banks the power of attorney for the sale of asset instead of transferring the property and iii) on the discharge (instead of which it was suggested that a way to invective the use of ALS would be to make it cheaper compared to other security rights in terms of tax and registration requirements).

Government and public authorities also underlined the uncertainties associated with the acquisition and realisation of the collateral as foreseen in the ALS especially in the case of real estate where a large number of burdens are associated with ownership entailing expenses, costs and risks. Moreover transferring the main assets to the bank would result in severe disruption of the normal business operations and deteriorates the ability of the firm to repay the remaining part of the loan (if the outstanding amount was higher than the value of the assets) as well as the ability to service other debts. Government and public authorities also stated that the creation of an independent European security instrument in addition to the existing security interests under national law could be seen as a sensible approach only if it could be integrated into the national legal orders (in particular property law and enforcement law) which differ substantially in MS according to their respective legal traditions and economic structures.

Law firms see the potential positive effects of ALS in avoiding accumulation of NPLs and improving lending as lenders will be equipped with pre-determined exit routes; however they caution that the appetite to enforce through an ALS would be lender-specific and voluntary hence limiting somewhat the potential effects. Moreover it is argued that the best value is rarely attained by forcing the repossession of asset as this leaves the bank with an asset which does not provide any productivity between repossession and sale. It is suggested by one respondent that repossession should not be the preferred route in the following cases: i) when mediation is possible; ii) the asset is in use, resale is not immediately available, the absence of the asset would worsen the situation of the borrower with no advantage for the lender; iii) the market for resale is insufficient to ensure that the repossession will be more profitable that a more operational solution.

Consumer associations, NGOs and private individuals provided comments on the features of the ALS: i) compulsory setting of a (minimum) value of the assets in advance by an independent expert, following the criteria that could be set out in the security right or in the loan contract; ii) there should be a mandatory duty to pay back the difference to the borrower once the asset is sold whenever the valuation of the asset leads to a value higher than the debt amount and iii) the mechanism trigger should be subordinated to a request by the bank to the borrowers for a revised business plan and possible restructuring – only in case of a failure to comply with this request the bank should be able to trigger the mechanism.

Business associations did not respond to the public consultation on ALS and did not express any views on this during the ad-hoc meeting but mainly on the less intrusive policy options (i.e. policy option 1 and 2).

The expert group was against creating a new security right (ALS) accompanied by an out-of-court enforcement mechanism. According to the experts, establishing a new security right would interfere too much with national legal systems and would be extremely complex insofar as very technical provisions are closely linked to national rules on security law, transfer of ownership, publicity requirements, and ranking of creditors in insolvency. Experts also pointed to the little value-added of establishing a new security right because the real problem does not rely in the absence of security rights in the Member States, but in the lack of efficient out-of-court mechanisms for enforcing existing security rights.

Annex 7 – Background information

I. Role of security interests and secured lending

Security interest is a legal instrument used by borrowers and lenders to secure the performance of a principal obligation. The security interest relies on so-called 'collateral' – e.g. assets (tangible or intangible, movable or immovable) granted by a borrower to secure a loan. A security interest right stands thus alongside the principal obligation, which is the loan agreed by the lender and the borrower. The lender can seize the collateral if the borrower fails to make the agreed-upon payments on the loan. The enforcement of the collateral therefore protects the lender from the borrower's default by allowing the creditor to recover value from the asset granted as collateral to compensate for the loss incurred with the failure of the borrower to pay back the loan. Collateral therefore contributes to reducing banks' risk exposure and loan loss[122]. Ideally, following the enforcement of the collateral the creditor should not incur any loss as a result of having granted a loan which has not been paid back by the borrower.

Enforcement refers to the ability of the creditor (collateral taker) to realise[123] the assets which have been granted as collateral by borrowers. A creditor acquires such a right to enforce collateral when the borrower is in default, meaning that the borrower does not fulfil the contractual terms of paying the loans under the terms and conditions agreed upon the signature of the loan agreement. Loan agreements specify what constitutes a default of the borrower for the purpose of allowing the creditor to enforce collateral. Enforcement can be done either in court, (judicial enforcement), or without the intervention of the judicial court. The latter is referred to as out-of-court or extrajudicial enforcement.

In loan agreements, the use of collateral strengthens (i.e. "secures") the right of the lender to obtain the performance of the loan obligations. In doing so collateral reduces perceived risk from a lender's perspective and thereby allows firms to more easily obtain the financing needed for their investment projects. Economic literature identifies several possible motivations for the use of collateral[124]: *ex ante* information asymmetries about the project quality (see Stiglitz and Weiss, 1981), *ex post* moral hazard issues with respect to the entrepreneur's effort and risk choices (for example Holmstrom and Tirole, 1997), limited contract enforceability (e.g. Cooley et al., 2004), and costly project monitoring (see Townsend, 1979, or Williamson, 1986). In essence, the foreclosure of collateral affects a borrower’s incentives to repay the loan because in case of failure to do so, assets given as collateral will be lost. This incentive effect may be further reinforced by the market practice of over-collateralisation, whereby lenders require collateral that covers more than the amount of the loan. Generally the extra amount of collateral is intended to cover possible loss should the asset be sold in a context of falling asset prices (so-called fire-sale). From a creditor's perspective, it is important not only to have the ability to enforce the collateral should the borrower fail to pay the loan, but also to be able to recover enough value to avoid a loss. For a

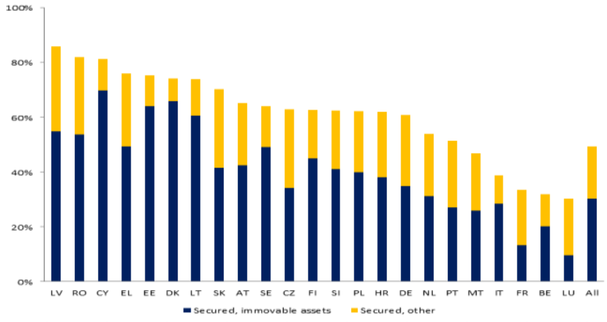
[123] Or appropriate the asset, depending on the type of the security right.
[124] Based on the review of this literature in Berger et al. (2011).

creditor to enforce collateral at a price which avoids incurring a loss, the enforcement procedure should be clear, swift and effective.

With a relatively lower probability of default and protection from the collateral, lenders may be more willing to lend their money to a risky but viable project, which otherwise would have not received financing and/or would be offered a very high interest rate. Economic research shows that collateralised lending is more commonly associated with riskier borrowers, but for a given borrower the fact to use collateral reduces the lending interest rates (Booth and Booth, 2006).

In the EU[125] as of December 2016 the stock of secured loans granted to non-financial corporations amounted to more than EUR2.5 trillion and represented around 50% of the total loans and advances to non-financial corporations. In the majority of the countries in the sample (18 out of 23) secured lending is predominant (more than 50% of total lending) with 8 countries showing level of share of secured lending higher than 70% of the total (see Figure 1 below).

Figure 15 – Share of secured loans in total loans and advances to non-financial corporations, 2016



Source: ECB Consolidated Banking Data; Note: data not available from Spain, UK, Bulgaria, Hungary, Ireland

II. Recovery procedures (judicial and non-judicial) in case of debtor's default

Insolvency is a financial state in which a natural or a legal person (a company) is unable to meet its financial obligations. Formal insolvency proceedings entail a judicial process, in which a judge assesses whether the company/individual entrepreneur is insolvent and considers what legal proceedings best fit the situation. Moreover, in order to avoid a disorderly run of creditors on the company, a set of rules and principles ensure trust and predictability of the procedures via setting up a certain order of repayment of creditors (*i.e.* ranking of creditors) and the equal and fair treatment for same (categories of) creditors (*i.e. pari-passu* and/or the *par condicio creditorum*). Before starting any formal procedure, the court has to declare the debtor as 'insolvent'.

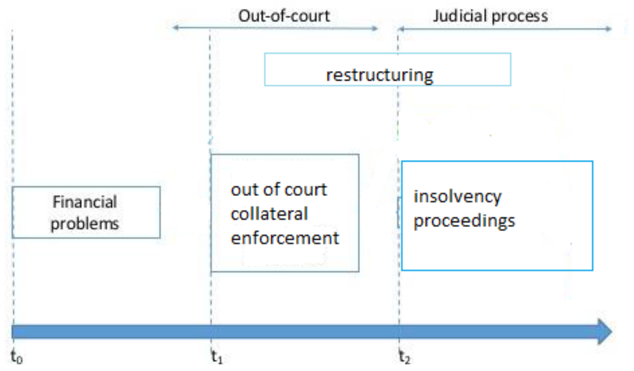
Growing recognition of the burden involved with the official insolvency proceedings, in terms of time and cost for recovering value, has led to much more focus on improving tools available before the company becomes insolvent. Preventive restructuring (also known as pre-

[125] Based on ECB consolidated data as of December 2016 (data not available for ES, UK, BG, HU and IE)

insolvency) proceedings are those actions that anticipate insolvency and overcome debtor's financial difficulties. Restructuring proceedings typically require a limited involvement of judicial court (*e.g.* creditors have to agree upon a "restructuring plan" to reorganise financial claims, which courts only evaluate and approve at the end of the process). In this way, the company, which has been considered as potentially viable, has the possibility to overcome its temporary financial difficulties and prevent the trigger of the insolvency proceeding.

In case of debtor's default in repaying back its loans, and before or regardless insolvency proceeding, other targeted out-of-court credit recovery procedures are usually possible. Such extra judicial enforcement mechanisms are not present in some Member States and when existing are not always efficient The focus of this impact assessment is on these extra judicial enforcement mechanisms.

Figure 16 – Timeline from default to insolvency proceedings



III. Related EU actions

This initiative fits within a wider range of actions already undertaken at European level. Section 2.3.1 presents the EU legislation adopted in the area of out-of-court enforcement of collateral but outside the scope of this initiative as it regulates the specific area of financial collateral. Section 2.3.2. summarises a recent Commission proposal on preventive restructuring and second chance proceedings which is currently discussed by the co-legislators. The document in the relevant sections also explains how the consistency between the latter and the initiative subject to this impact assessment will be assured.

III.A Financial Collateral Directive

With the Financial Collateral Directive (FCD)[126], a European regime was introduced for the provision and enforcement of collateral under the form of securities, cash and credit claims. The types of arrangements covered by the FCD are title transfer financial collateral arrangement and security financial collateral arrangement. The latter encompasses mortgages, pledges, fixed charges, floating charges and liens.

[126] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32002L0047

The only harmonised rules on extrajudicial enforcement refer to specific category of financial collateral where the collateral taker and the collateral provider belong to one of the following categories: a) a public authority, b) a central bank, c) a financial institution subject to prudential supervision, d) a CCP, e) a person other than a natural person, including unincorporated firms and partnerships, provided that the other party is an institution as provided in points a) to d).

The objective of the FCD was to harmonise the process for creating and enforcing financial collateral. In cases where parties agree to this in writing, the collateral taker can "appropriate" the collateral without a court order for disclosure.

The initiative on out-of-court enforcement of collateral under the form of movable and immovable assets would not interfere with the collateral governed by the FCD, but aims at making available such out-of-court enforcement to secured creditors in the case of loans granted to companies and entrepreneurs. The scope of this initiative would be different than the scope of the FCD.

III.B Commission proposal on preventive restructuring and second chance

In November 2016, as had been announced in the 2015 CMU Action Plan, the Commission tabled a legislative proposal on "*preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures*"[127]. That proposal sets common principles on the use of early restructuring frameworks to help viable companies continue their activity and rules to allow entrepreneurs to benefit from a second chance and a full discharge of debts. It will also provide prescriptions that help to make the insolvency proceedings more effective within the EU. **One of the main achievements of the proposal will be to improve the efficiency of the use of Member States' judicial systems in the context of insolvency and restructuring**:

- Flexible preventive restructuring frameworks will reduce the formal recourse to courts. However, where necessary or deemed useful, the courts will be involved in restructuring proceedings to safeguard the interests of all the relevant parties.
- Specialised judges and practitioners as well as purpose-built technology in the data collection will improve the efficiency of insolvency procedures and reduce their cost and length.

The proposed Directive focuses on three key elements:

- Common principles on the use of early restructuring frameworks, which will help companies continue their activity and preserve jobs.
- Rules to allow entrepreneurs to benefit from a second chance, as they will be fully discharged of their debt after a maximum period of 3 years.
- Targeted measures for Member States to increase the efficiency of insolvency, restructuring and discharge procedures. This will reduce the excessive length and costs

[127] Proposal on "preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU" -see http://ec.europa.eu/information_society/newsroom/image/document/2016-48/proposal_40046.pdf.

of procedures in many Member States, which results in legal uncertainty for creditors and investors and low recovery rates of unpaid debts.

The new rules will observe the following key principles to ensure insolvency and restructuring frameworks are consistent and efficient throughout the EU:

- Companies in financial difficulties, especially SMEs, will have access to early warning tools to detect a deteriorating business situation and ensure restructuring at an early stage.
- Flexible preventive restructuring frameworks will simplify lengthy, complex and costly court proceedings. Where necessary, national courts must be involved to safeguard the interests of stakeholders.
- The debtor will benefit from a time-limited "breathing space" of a maximum of four months from enforcement action in order to facilitate negotiations and successful restructuring.
- Dissenting minority creditors and shareholders will not be able to block restructuring plans but their legitimate interests will be safeguarded.
- New financing will be specifically protected increasing the chances of a successful restructuring.
- Throughout the preventive restructuring procedures, workers will enjoy full labour law protection in accordance with the existing EU legislation.

Training, specialisation of practitioners and judges and the use of technology (e.g. online filing of claims, notifications to creditors) will improve the efficiency and length of insolvency, restructuring and second chance procedures.

This initiative on out-of-court enforcement of collateral is shaped in a way to ensure full consistency and complementarity with the Commission proposal on preventive restructuring frameworks. While the former refers to extra-judicial enforcement of collateral, the latter aims at providing for a harmonised judicial framework on preventive restructuring and second chance for companies and entrepreneurs. The extra-judicial enforcement of collateral would be possible as long as a preventive restructuring is not commenced. The commencement of a preventive restructuring procedure, i.e. a collective or semi-collective procedure involving all or a significant part of the debtor's creditors, shall suspend any individual enforcement actions on the part of creditors, be they judicial or extra-judicial actions.

IV. The size of the NPL problem in the EU

The gross carrying amount of NPLs in the banking system in the EU at the end of 2016 amounted to around EUR 1 trillion representing almost 7% of EU GDP while the net amount, taking into account loan loss provisions, stood at almost EUR 0.55 trillion a figure which is close to more than all the capital banks raised since 2011, more than six times the annual profits of the EU banking sector, or more than twice the flow of new loans[128].

[128] http://voxeu.org/article/search-european-solution-non-performing-loans

The NPL ratio[129] for the EU banking system is slowly decreasing, and amounts to 5.1% in December 2016 (from 6.5% in December 2014 and 5.7% in December 2015). The decrease in the ratio has been driven mainly by an actual decrease in NPLs, but also by an increase in total loans. The EU level remains higher than in other major developed countries: in comparison, the World Bank reported NPL ratios of about 1.5% for the United States and Japan at the end of 2016. **In particular, compared to the financial crisis in the US, the recognition of losses has been slower in Europe than in the US (NPLs ratios peaked in 2012 in the EU vs 2009 in the US), and the subsequent reduction in NPLs is also more gradual.**

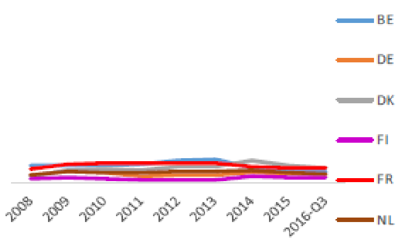
The reduction in NPLs observed over the past years however has been uneven across Europe and the NPL ratio is highly dispersed across EU countries ranging from 1 % to 46%. As such Member States can be classified in the three categories (see Table 19):

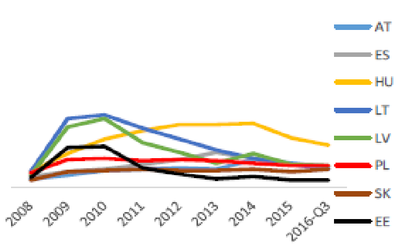
- 9 Member States with low levels of NPLs, and with no significant rise in NPLs during the crisis (group/category 1: Belgium, Germany, Denmark, Finland, France, Luxembourg, the Netherlands, Sweden, UK);
- 9 Member States with low levels of NPLs but which have reported a high level or a high increase of NPLs during the crisis (group/category 2: Austria, Czech Republic, Estonia, Spain, Hungary, Lithuania, Latvia, Poland, Slovak Republic);
- 10 Member States with currently high level of NPLs (group/category 3: Bulgaria, Cyprus, Greece, Croatia, Ireland, Italy, Malta, Portugal, Romania, Slovenia)

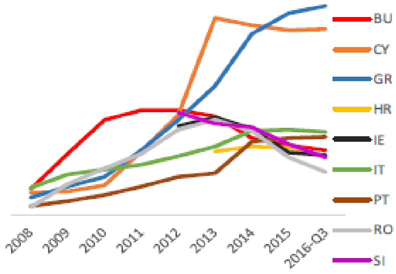
[129] Average of NPLs/ total loans weighted by total loans

Table 19 – NPL ratios in Member States as of December 2016

MS	NPL ratio	Forb. ratio	Cov. ratio	NPL * (bnEUR)	% total*	Evolution of non-performing exposures
Group 1: low level of NPL and no significant increase throughout the crisis						
BE	3,2%	1,6%	44%	21	2%	
DK	3,1%	1,9%	30%	20	2%	
FI	1,6%	1,7%	30%	4	0%	
DE	2,5%	2,1%	37%	68	6%	
LU	1,1%	0,3%	45%	2	0%	
NL	2,5%	2,4%	35%	45	4%	
FR	3,7%	1,2%	52%	148	14%	
SE	1,0%	1,1%	29%	11	1%	
UK	1,9%	1,4%	30%	91	8%	
		Total Group 1:		**410**	**37%**	
Group 2: relatively low level, after a significant increase during the crisis						
AT	5,3%	3,2%	55%	25	2%	
EE	1,3%	2,0%	32%	0	0%	
CZ	2,5%	0,8%	63%	2	0%	
PL	6,1%	2,4%	59%	7	1%	
HU	11,5%	5,5%	64%	6	1%	
SK	4,2%	2,0%	55%	2	0%	
ES	5,7%	6,2%	44%	141	13%	
LV	3,2%	4,4%	29%	0	0%	
LT	3,8%	3,1%	30%	1	0%	
		Total Group 2:		**184**	**17%**	
Group3: high level of non-performing loans						
BG	12,5%	7,8%	58%	2	0%	
HR	10,1%	5,1%	63%	3	0%	
CY	44,8%	26,4%	40%	21	2%	
EL	45,9%	23,2%	48%	115	11%	
IE	13,6%	12,7%	35%	33	3%	
IT	15,3%	5,4%	49%	276	25%	
MT	4,4%	4,2%	36%	1	0%	
PT	19,5%	12,7%	44%	41	4%	
RO	10,1%	6,1%	66%	3	0%	
SI	14,4%	9,7%	64%	3	0%	
		Total Group 3:		**499**	**46%**	
EU	**5,1%**	**3,2%**	**45%**	**1092**	**100%**	





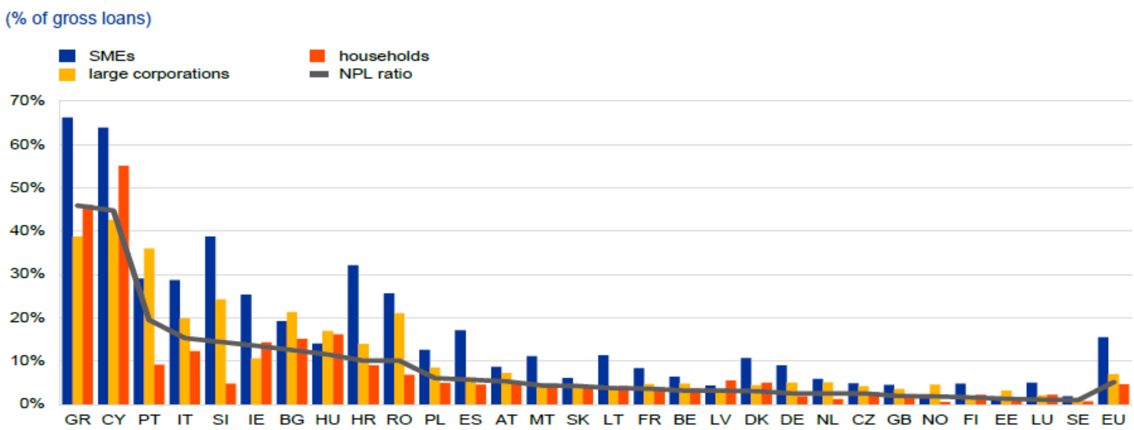


Source: EBA, ECB (* refers to data available as of June 2016)

More than half of currently impaired loans were extended to non-financial companies[130]. The NPL problem is particularly acute for SMEs as the ratio of exposures towards small and medium-sized enterprises (SMEs) is higher (16.7%) than for exposures towards large corporates (7.5%) and households (4.7%) (see Figure 17 below). Higher NPL levels in SME lending may be related e.g. to their greater reliance on bank financing, lower diversification, and more difficult financial situation. Additionally, recoveries on SME lending may be lower due to, among other factors, for instance the fact that enforcing collateral on SMEs can be much more complex than on households (as a large part of household debt is secured by mortgages) when enforcement is the adopted strategy[131]. Probability of default rate is also higher for SMEs than for larger companies.

[130] 61% as of Dec 2015 – ESRB Secretariat Based on Consolidate banking data - ECB
[131] FSC Report

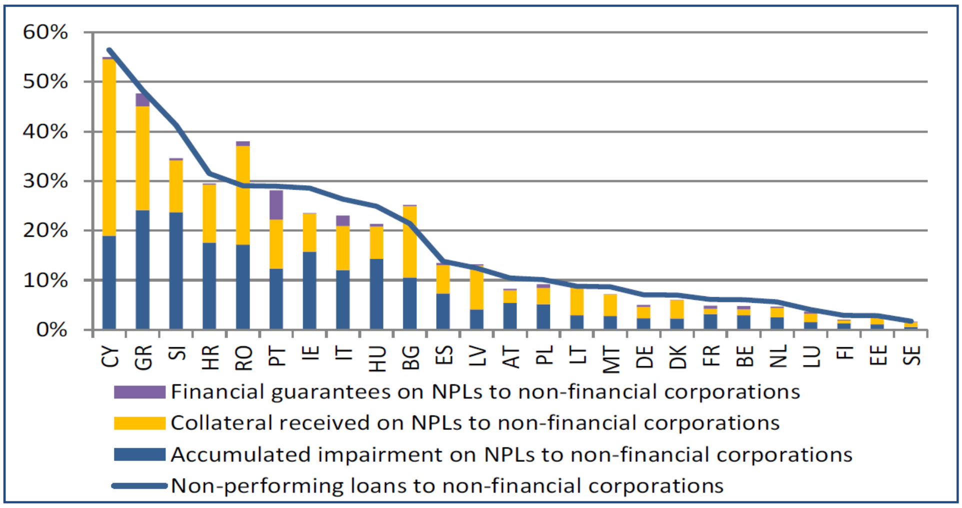
Figure 17 – Non-performing loan ratios by borrower category



Source EBA; Note: Data refer to end-2016

Finally focussing on NPLs to non-financial corporations and in particular on the relationship between the collateral and loan loss provisions (i.e. accumulated impairment), figure 6 below shows that valuation of collateral in the books of the banks is an important source of theoretical coverage of non-performing loans.

Figure 18 – Non-performing loans to non-financial corporations and coverage (% of total gross loans to non-financial corporations)



Source FSC report - Data refers to Q3-2015 - Consolidated Banking Data (ECB). No data for Czech Republic, Slovakia and the United Kingdom. Member States are ordered according to the ratio of non-performing loans to non-financial corporations to total loans to non-financial corporations

Box on cross-border lending[132]

Cross-border banking brings important stability and risk-sharing benefits, through its effects

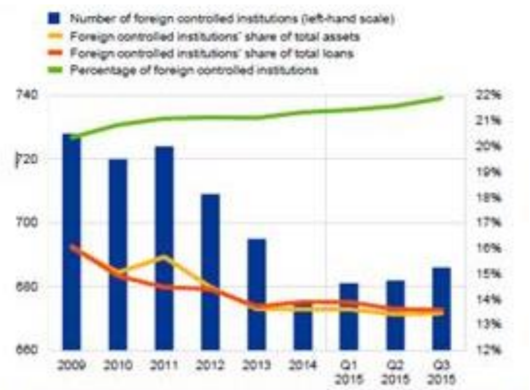
[132] Box based on ECB (2017): "Cross-border banking in the euro area since the crisis: what is driving the great retrenchment?", Financial Stability Review, November 2017.

on risk diversification. Financial integration in banking markets not only has aspects related to the pricing of loans, but also has aspects related to the quantity of loans provided. Banks can provide cross-border credit either locally, through their affiliates, or via direct cross-border loans. Growing EU (and especially euro area through the banking union) business activity through one of these channels would signal that banking markets are well integrated and that benefits from efficient allocation of savings to the best investment opportunities are being fully exploited. Contraction of cross border lending can either signal frictions in the integration of financial markets or differential developments of profitable investment opportunities across countries.

Cross-border credit provided by local affiliates of foreign banks seems to be stable at low levels. Cross-border lending to NFCs via direct cross-border loans in the euro area has been showing an upward trend, but at low levels:

i) Cross-border credit provided by local affiliates of foreign banks stagnated in total. The share of both total assets and total loans of non-domestic affiliates remained at low levels of around 14% (*Figure 19*). This number masked high cross-country heterogeneity: whereas in large countries the shares were below 10%, most of the small countries had shares of more than 80%. Non-domestic affiliates had on average much lower total assets and total loans than domestic affiliates. Overall, the total number of non-domestic affiliates in euro area countries steadily declined as from 2011, which is line with the general trend of reducing bank affiliates in the euro area

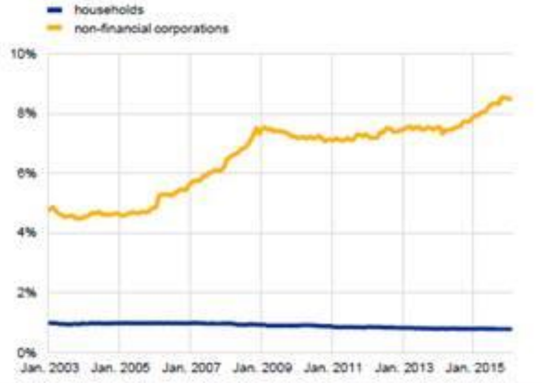
Figure 19 – Non-domestic affiliates in euro area countries



Source: ECB (consolidated banking data); Notes: Total number (left-hand scale), percentages (right-hand scale). Foreign-controlled affiliates comprise foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches.

ii) Cross-border bank lending via direct cross-border loans in the euro area seemed to be on an upward trend. The share of cross-border loans to non-financial corporations, which account for around 8% of all loans to non-financial corporations, continued to grow, albeit at a slow pace

Figure 20 – Share of cross-border loans in the euro area by sector



Source: ECB (BSI statistics); Notes: Percentages per annum. Cross-border loans include loans to other euro area countries for all maturities and currencies. Interbank loans do not include central bank loans.

It is important to note the importance of the cross-border dimension within the NPL problem. Analysis in the Report of the FSC Subgroup on Non-Performing Loans[133] shows that, as at 2016, foreign-owned banks faced somewhat lower corporate NPL problems than their domestically owned peers across EU Member States. Nevertheless, the extent of the NPL problems remains significant even for these foreign-owned entities, especially given that the observed NPL differences might be due to a conservative selection of corporate counterparties by foreign-owned banks precisely due to differences in enforcement frameworks.

Better cross-border out-of-court collateral enforcement rules and more predictability can have a positive effect on lending (both cross-border and domestic) in these three cases:

- Direct cross-border lending (i.e. Italian bank lending to Spanish corporate on a secured basis with Spanish collateral) → cross border lending and cross border enforcement

- Indirect cross-border lending through a subsidiary (i.e. Italian group with a Spanish subsidiary lending to a Spanish corporate on a secured basis with Spanish collateral) → this is considered cross-border lending but the contract and the collateral enforcement are not cross-border as these are all in Spanish; however the headquarters of banking groups still exert significant control on the overall lending activity of the subsidiaries: in this simplified example the Italian group trusting the out-of-court collateral enforcement in Spain (as similar to the Italian one thanks to an harmonized system) will channel more money to the Spanish subsidiary hence increasing cross-border lending

- Small Italian bank (so no subsidiaries or foreign holding companies above) lending to a Spanish corporate on a secured basis with Belgian collateral → this is considered domestic lending but with cross border enforcement

V. (First-order) comparison of the efficiency of the judicial system

A first-order comparison of the efficiency of the judicial system in different countries can be based on the World Bank Doing Business data, which are a series of annual surveys measuring regulations and procedures that are essential for business activity. Among the areas

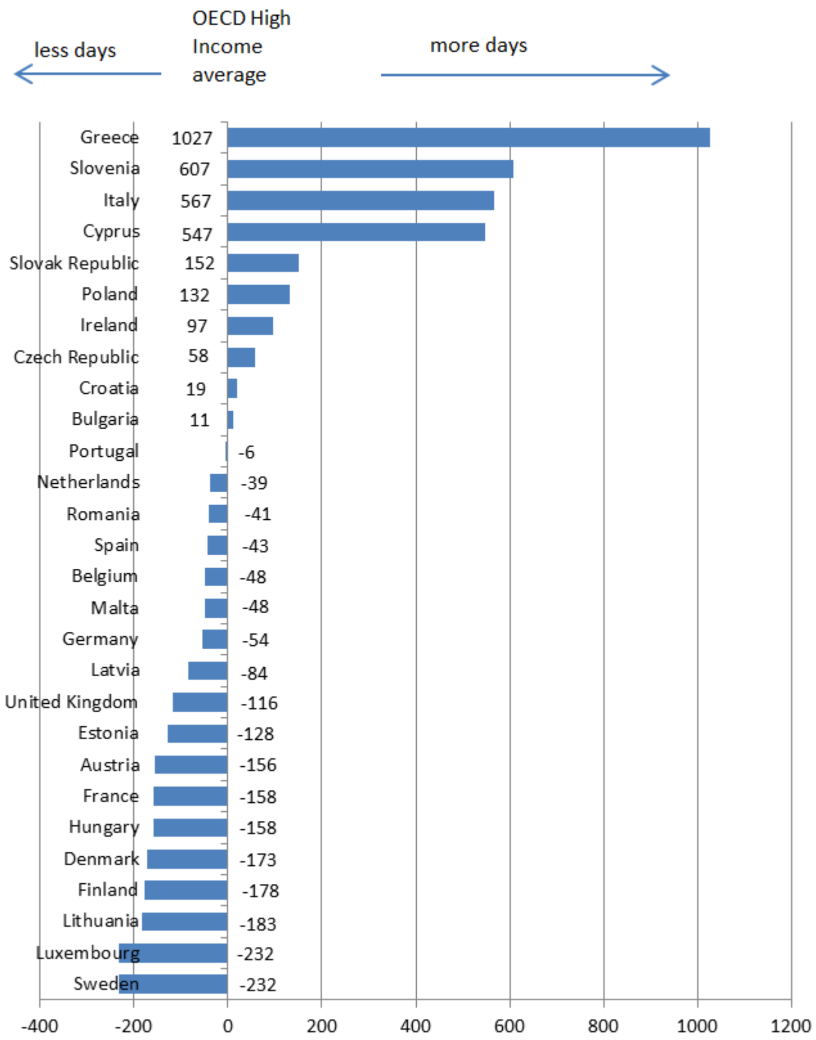
[133] Report of the FSC Subgroup on Non-Performing Loans, EF 113 ECOFIN 481, May 2017.

included (latest data current as of June 1, 2016) is the ability to enforce contracts which is related to the efficiency of the judicial system (and ultimately reduces the risk of insolvency and related litigations). The graph below shows how the EU as a region fare compared to other extra-EU regions and the situation in the 28 Member States on the number of days required to enforce a contract through courts including i) time to file and serve the case; ii) time for trial and to obtain the judgment; iii) time to enforce the judgment. Although the indicator is based on the number of simplifying assumptions and on hypothetical test case (the dispute of the breach of a sales contract between 2 domestic businesses[134]) it can used as useful indicator of the efficiency of the judicial system and can be compared across 190 economies.

In terms of time to enforce a contract, the EU as a region is performing worse than the OECD high income countries, with four Member States (Greece, Slovenia, Italy and Cyprus) well above the average. The latter have estimated values of more than 1100 days (*i.e.* 3 years). Incidentally these are also the countries with the highest level of NPLs. Conversely the Member States at the far right of the chart (*i.e*. those with the fastest enforcement procedure) are among those with the lowest level of NPLs.

[134] Although the judicial enforcement of collateral is a different case compared to a dispute of the breach of a sales contract many procedural steps are common for both making the indicator also a good proxy for the former.

Figure 21 – Number of days needed to enforce a contract trough the courts



Source: Doing business 2017

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