European Commission Action Plan for NPLs

1 Introduction

On 16 December 2020 the European Commission unveiled a strategy to prevent a future accumulation of non-performing loans ("**NPLs**") on banks' balance sheets across EU member states as a result of the Covid-19 pandemic (the "**NPL Strategy**"). The core objective of the NPL Strategy is to support a liquid secondary market for NPLs so that banks are in a position to continue to lend through the post Covid-19 recovery.

A high volume of NPLs on banks' balance sheets would inhibit their ability to lend as a result of the obligation placed on financial institutions to hold capital against such vulnerable exposures under the Capital Requirements Regulation No. 575/2013 ("**CRR**"). The amount of distressed loans across the EU is expected to rise in 2021 after the expiration of (i) mortgage repayment holidays for private individuals and (ii) temporary relief measures for companies, which were introduced when member states went (or returned) into lockdown.

In this publication we will first summarise the main elements of the NPL Strategy before providing some analysis on certain of the proposals together with some market reaction.

2 Key elements of the NPL Strategy

The NPL Strategy is comprised of four main pillars as set out below:

PILLAR 1

The development of secondary markets for distressed assets

A key aspect of the NPL Strategy is facilitating the development of a fluid secondary market for disposals of NPLs by banks. As referenced above, under CRR, banks are required to hold capital against exposures to NPLs thereby limiting their capacity to lend. The European Commission believes credit will be essential for corporate funding (particularly for SMEs) in the post Covid-19 world and therefore it wants to ensure that banks will be able to divest themselves of impaired loans and continue to lend to fuel economic recovery.

This pillar of the NPL Strategy includes the following proposals:

(1) There is a need to reach an agreement for a directive on credit servicing

The European Commission believes that an immediate aim of the NPL Strategy should be to finalise the proposed EU directive on credit sales and credit servicing (the "**Credit Servicing Directive**"). The Credit Servicing Directive is intended to help bolster a secondary market for NPLs by: (i) creating a framework for the authorisation of credit servicers throughout the EU and

(ii) establishing rules for disclosure and transparency of information from a credit seller to a credit purchaser prior to concluding a loan sale. On 14 January 2021 the Economic and Monetary Affairs Committee ("**ECON**") MEPs overwhelmingly voted in favour of the draft text of the Credit Servicing Directive. The ECON MEPs also agreed to commence negotiations with the European Commission and the European Council in order to progress the directive.

(2) Improving data quality and data comparability

Fundamentally one of the biggest logistical barriers to NPL sales is the time and resources required for legal and financial due diligence by prospective buyers. This proposal seeks to harmonise the diligence process by utilising a standardised form of data templates.

(3) Data infrastructure

To increase market transparency, the European Commission proposed establishing a central data hub at EU level which would act as a data repository supporting the NPL market. The hub could help establish a common data standard (increasing the use of the European Banking Authority ("**EBA**") data template as the standard for conducting NPL transactions), offer data quality checks and automated validation, and assist sellers with their data preparation for reporting.

The hub could collect and store anonymised data on NPL transactions which would be accessible by market participants, such as NPL sellers and buyers, credit servicers and private NPL platforms. This would allow market participants to compare transactions and gain insights into the actual pricing of assets and market liquidity.

(4) Leveraging existing data resources

There are a number of data sources that already exist and which could form the basis of regular reports on aggregate information that could be made available to secondary market participants. Examples of such resources include: (i) the European Central Bank's 'Analytical Credit Dataset' ('AnaCredit'), which collects and shares granular credit risk data within the EU banking sector, (ii) securitisation repositories and (iii) data reporting by banks on time to recovery and recovery rates.

(5) 'Best execution' sales process

By Q3 2021 the European Commission, following engagement with the EBA and other market stakeholders, aims to develop a framework on efficient sale processes with respect to NPLs. This is intended to be of particular assistance to smaller banks or sellers with less experience of secondary market disposals. The process is expected to include the adoption of a common set of due diligence materials, the use of EBA data templates for the disclosure of information and the acceptance of bids electronically, amongst other things.

(6) Address regulatory impediments to NPL purchases by banks

If a bank purchases an NPL in a scenario where the purchase price for such NPL is less than the risk adjusted value for the same NPL applied by the selling bank, the buyer may not be able to benefit from a lower risk weighting with respect to any unsecured amounts comprised in the exposure. In other words it would have to carry the exposure at the risk adjusted value set by the seller and could not carry it at a level to reflect the lower purchase price.

In the NPL Strategy, the European Commission indicates that it intends to engage with the EBA in early 2021 to agree an approach which would reduce the risk weighting on purchased defaulted assets to an appropriate level. This would hopefully "level the playing field" as between banks looking to acquire NPLs and encourage banks to buy NPL portfolios.

PILLAR 2

The use of asset management companies

The NPL Strategy favours the use of Asset Management Companies ("**AMCs**") across member states in order to incubate and work out defaulted loans. The European Commission believe AMCs to be particularly effective in scenarios where impaired assets contaminate large parts of domestic banking systems and stunt domestic lending. The European Commission suggests that AMCs could be centralised at a national level or be established for specific banks.

The NPL Strategy outlines that AMCs should have substantial financial means in order to acquire NPLs and the European Commission expressed a preference for AMCs to be privately funded, however, it did acknowledge that this may be challenging and state intervention such as by means of a government guarantee may be necessary. The NPL Strategy also suggests that AMCs across member states could cooperate across the EU to share best practices and coordinate creditor actions as needed. The European Commission accepts however that such coordination may be difficult as it may not be possible to have a homogenous approach to an AMC which will work across all member states.

Matheson

PILLAR 3

The reform of the EU's insolvency and debt recovery frameworks

Another short term objective of the European Commission is to urge the European Parliament and European Council to reach an agreement on a legislative proposal for minimum harmonisation rules on accelerated extrajudicial collateral enforcement ("**AECE**"), with respect to non-consumer loans only. As part of the 2017 European Council NPL Action Plan a benchmarking exercise was undertaken to examine the differences in recovery rate and speed by banks across member states with respect to NPLs. This has informed the European Commission of the harmonisation which may be required across member states in order to facilitate better work outs of NPLs and underpin a liquid market for such assets. The European Commission believes that reaching agreement on AECE is necessary in order to provide an expedited and efficient way to enforce security against business borrowers across the EU whilst at the same time not impacting legal protections borrowers have under existing law (an example under Irish law would be the ability to apply for examinership in certain situations).

PILLAR 4

The use of the EU's bank crisis management and State aid framework

As mentioned above, the European Commission favours a private sector solution to the expected rise in NPL sales but recognises that, depending on the scale of the situation, state support may be required. The European Commission believes that any state intervention in this regard should be applied sparingly and only where justified and appropriate with respect to stabilising a bank which was otherwise healthy prior to the COVID-19 pandemic.

3 Key take away points

Credit Servicing Directive and Ireland

Ireland has its own domestic credit servicing regime which has evolved over time by way of amendments to the Central Bank Act 1997 (the "**Irish Credit Servicing Regime**"). The most recent amendments to the Irish Credit Servicing Regime in 2018 have had the effect of bringing the following activities in scope of the requirement to become authorised by the Central Bank of Ireland: (i) holding legal title, (ii) determining the overall portfolio strategy and (iii) maintaining control over key decisions with respect to a loan portfolio.

In contrast to the Irish regime, the proposed Credit Servicing Directive does not seek to regulate any of the above three activities and in particular does not focus on the role of the credit purchaser, instead, the proposed Credit Servicing Directive focuses on the pure credit servicing activities such as administering the performance of the credit agreement, liaising with borrowers and enforcing rights under the relevant credit agreement.

The implications of the potential discrepancies between the EU and Irish approaches on credit servicing are that, if the proposed Credit Servicing Directive were to be transposed into Irish law (substantially in its current draft form) then the Irish Credit Servicing Regime would need to be amended in order to accord with the Credit Servicing Directive. The effect of such an outcome would be to make the role of a credit purchaser that holds legal title or controls or determines strategy less onerous from a regulatory perspective in Ireland.

Increased Competition

The central objective of the NPL Strategy is to provide a framework for a liquid secondary market with respect to NPLs. In order to facilitate such a liquid market the European Commission have focused on removing barriers to smaller sellers and buyers of NPLs. This is apparent in several of the pillars of the NPL Strategy such as harmonising the diligence process and demystifying enforcement. Reducing costly risk weighting requirements may also bring smaller buyers to the table. A desired outcome for the European Commission is that NPLs may be disposed of in smaller tranches thereby avoiding unnecessary accumulations on the balance sheets of banks and ultimately opening the door to buyers who would not previously been in a position to purchase large scale distressed portfolios.

Transactional benefits

Certain of the pillars of the NPL Strategy are inherently aimed at easing the transactional burden of completing an NPL sale, such as the use of standardised EBA data templates as part of the diligence process and the proposals for a "best execution" framework. Whilst presumably both sellers and buyers alike would welcome this harmonised approach it raises the question as to whether it will be practically possible to achieve a common infrastructure across member states given the diversity of legal frameworks which exist across the EU. The NPL Strategy does however acknowledge that the EBA will need to review the templates based on a consultation with market participants (both on the buyer and seller side), which is due to take place in the course of 2021. The overall timing for achieving any level of harmonisation remains unclear.

Enforcement of security

AECE is a proposed form of extrajudicial enforcement process which would allow creditors to realise collateral by public auction or private sale. AECE would be strictly limited to loans granted to business borrowers and would require prior agreement between the lender and borrower in the loan documentation in order to be utilised. It is clearly desirable to make enforcement more efficient across the EU and provide for a harmonised approach in relation to enforcement remedies. Hopefully progress will be made on this proposal in the short term with a view to helping to resolve NPLs, achieve a more liquid secondary market for NPLs and encourage new lending to SMEs in particular.

It is proposed that AECE will not prejudice other enforcement remedies available under national laws. In Ireland we do have well developed enforcement remedies which do not involve court processes already. AECE in the final form it takes may well be introduced in Ireland but in our view, it is unlikely to be utilised widely in Ireland in its current form having regard to other remedies that are already available.

Risk Weighting

If the risk weighting applied to purchased defaulted assets can be adjusted to an appropriate level this will have a material impact on regulated buyers capacity and appetite to buy NPLs and fundamentally it will help fuel liquidity for the NPL market. If implemented it will have the effect of freeing up expensive capital held against that exposure (for the purposes of CRR) which could then be redeployed elsewhere. It might also open the door to more regulated buyers who may not otherwise have acquired NPLs and potentially increase values offered for NPLs if the longer term cost of the transaction to a buyer is effectively reduced.

Asset Management Companies

There are clearly differing views as to how AMCs could be utilised as part of post Covid-19 recovery. Calls for an EU wide bad bank have been ignored, the European Commission favours national AMCs but leaves the door open to AMCs for specific financial institutions.

4 Market reaction

The NPL Strategy has been met with mixed reviews. Certain market commentators welcomed the proposals particularly those relating to facilitating an easier due diligence process and the sharing of data. It is interesting to note however that the Association for Financial Markets in Europe ("**AFME**"), a banking industry body, described the NPL Strategy as "unambitious" and won't be enough to address a post Covid-19 build-up of bad loans although they did welcome the proposals for a more harmonised insolvency framework[1].

In addition the European consumer organisation BEUC described how the NPL Strategy left borrowers vulnerable to investment funds that would act EU wide with minimal oversight and aggressively seek repayments from borrowers. On the topic of borrower vulnerability, the EU financial services commissioner, Mairéad McGuinness, stated that "a deep, liquid and transparent secondary market

1 https://www.afme.eu/news/press-releases/AFME-Commissions-revised-action-plan-for-NPLs-from-Covid-19-disappoints
2 https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_20_2459

can help reduce NPLs, while maintaining strong borrower protection”[2].

Some market participants have placed particular emphasis on the failure to adhere to suggestions from the European Central Bank’s head of banking supervision, Andrea Enria who called for an EU wide bad bank. AFME on the other hand queried the value of AMCs generally and believe that “in most cases banks are more likely to maximise returns from their NPLs by retaining management control of these assets, while at the same time remaining connected to their impacted clients” .

5 Conclusion

It is encouraging to see that the European Commission is taking proactive steps to deal with and manage the likely increase in NPLs following the Covid-19 pandemic. However the framework does raise many talking points. It is likely that the overall concept of a more liquid market for NPLs will be welcomed by many market participants, certainly potential sellers. One thing seems clear, the detail will take some time to be finalised.

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