Finance Watch response to the European Commission's public consultation on the development of secondary markets for non-performing loans and distressed assets and protection of secured creditors from borrowers' default

Brussels, 20 October 2017

Finance Watch is an independent non-profit Members' association set up in 2011 to act as a public interest counterweight to the powerful financial lobby. Our mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and citizens. Our Members are civil society organisations and expert individuals, supported by a full-time secretariat.

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We agree to the publication of this response.

General Comment

Finance Watch welcomes the opportunity to provide comments on the Commission's consultation document on the development of secondary markets for non-performing loans and distressed assets and protection of secured creditors from borrowers' default.

We recognise that the issue of high levels of non-performing loans (NPLs) may hamper banks' ability to lend, including to SMEs. However, we would also like to raise some issues related to the way forward with managing NPLs in the EU.

Firstly, we would like to mention that whilst we recognise the impact of the financial crisis and subsequent recessions on the levels of NPLs in the economy, there is still a high geographical concentration of NPLs and within certain types of banks. In this respect, any resolution of the NPL situation should also be supported by a closer examination of the long-term viability of these banks and whether specific lending practices or systems of control have given rise to a high level of NPLs on a bank's balance sheet. Related to this is the issue of resolution. We would encourage the Commission to consider that solving the NPL issue of a bank may not lead to an overall improved economic situation of the institution and in these cases resolution tools should be put into action.

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We recognise that there is a limited market for NPLs in the EU and that this means a lack of competition and can hamper efficient pricing. This may lead to unnecessary losses for banks' seeking to sell their NPLs. However, we would caution against any strategy to deal with this that involves the government and tax-payer stepping into the NPL space either directly or through support for investors who take this on. Banks need to be incentivised to address their NPL issue and implicit or explicit government support will not tackle the underlying issues related to NPLs and does not provide incentives for better management of loan portfolios going forward. Therefore, we believe that supporting a deeper and better functioning secondary market is a good aim.

We also recognise that this is not a simple or easy task and that there may be issues with finding investors for this distressed debt. Therefore, we would support the development of industry-funded vehicles that could be a buyer for NPLs. These vehicles must not benefit from any state support, but instead must be fully funded by the industry. This would allow for banks to move NPLs from their balance sheet without incurring the moral hazard issues of a tax-payer funded solution. We are also supportive, in principle, of sales of distressed portfolios to privately-funded, dedicated distressed debt funds, provided always that these are adequately supervised, i.e. under a regulatory framework that is broadly equivalent to that of the selling entity.

We are very sceptical, however, about the sale of distressed debt on the capital market by way of issuing structured debt securities. Distressed debt is, by definition, a high-risk asset class, they need to be managed actively by professionals and returns are closely linked to the performance of the work-out team or asset manager. Recovery rates are likely to be optimised, arguably, if the incentives of managers and investors are aligned as closely as possible. This would indicate that on-sales of distressed portfolios to the market by way of securitisation should not be encouraged. In particular, we would strongly advise against these assets being sold, directly or indirectly, to retail investors.

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? If yes, would you consider such obstacle to be significant?

Evidence from recent examples have shown that the number of distressed funds bidding for EU NPLs is low. This lack of demand can give rise to issues with competition and with efficient pricing for these NPLs. A larger and deeper market would allow better competition for these NPLs and in turn would improve the pricing in the market. Additionally, it has been evident in the market that many of the funds involved in the purchase of EU NPLs are based outside of the EU, demonstrating a lack of presence of EU distressed funds in the market. Whilst this could be seen as a positive as it diversifies the risk of these NPLs away from the EU, it also means any opportunities that arise from the resolution of these NPLs is also not located within the EU (outside of the removal of the NPLs from European banks' balance sheets).

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Question 2: What are the key considerations for banks in deciding whether loan sales should be a significant part of their strategy to manage its NPLs?
In answering please specify:
- bank internal factors (i.e. any factors inside the bank including the type and characteristics of the NPL portfolio, management capacity etc.)
- external factors (i.e. any factors outside of the bank that are important considerations in this context.

Bank internal factors:

We believe a key factor for banks will be how well capitalised the bank is. The bank must have sufficient capital to be able to absorb the writing down of the NPLs. Banks that have access to the capital markets should be encouraged to use it, while still available, to address emerging NPL problems in a proactive manner.

Another key factor will be whether they have the capability in house to do the workout work involved. A lack of specific expertise will mean that they may not be able to conduct the work themselves, which may make the sale of the loan less attractive.

Additionally, the size of the NPL problem for a particular bank will influence their decision on how to handle their NPLs. The larger the NPL issue, the more solutions a bank will have to consider and this could include the sale of the NPLs.

External factors:

The major external factor will be whether there is a market for the NPLs. In the absence of a well-functioning market, banks may be unable to sell or may be unwilling to sell as a limited market may lead to less efficient pricing of the portfolio and therefore unnecessary losses incurred by them.

The availability of government support for the disposal of NPLs is another significant factor. Finance Watch does not support the use of public funds to facilitate the disposal of NPLs unless there is a genuine and acute risk of systemic contagion.

Question 3: What would be the best way(s) of attracting a wider investor base to secondary loan markets, especially for non-performing loans?

Whilst we would support a wide base of institutional investors for NPLs, we would also caution that any widening of the investor base should not include any risk to retail investors. Therefore, NPLs should not be marketed to retail or non-institutional investors either directly or indirectly. Additionally, public funds should not be placed at risk in the disposal of NPLs and therefore we would discourage the use of public funds to widen the investor base for NPLs (for example through explicit or implicit government support to investors investing in NPLs).

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We believe the best way to encourage a wider investment base for NPLs is through well-managed, competitive auctions with selected institutional investors. Ahead of these auctions the portfolio must be thoroughly analysed and documented and assembled into homogenous portfolios of marketable size. Transparency over the assets in the portfolios will be key in attracting investors.

Question 4: In order to widen the investor base, please specify
- which incentive(s) should be given?
- whether certain obstacles to widening the investor base should be removed?

We believe the best incentives for investors is to ensure a professional and transparent process to the sale of NPL portfolios. We would echo our comments in response to question 3 that public funds should not be used to incentivise investors to take on the portfolios.

Question 5: What are the specific advantages to the development of secondary markets when the acquiring investor is a bank, an investment fund or another type of entity?

In particular, would you see specific advantages for
- helping banks overcome legacy assets;
- creating investment opportunities for specialised investors?

We believe that the appropriate investors for NPLs should be dedicated managers of distressed funds so we would be cautious about another bank purchasing NPLs. However, if such a bank had specific, dedicated staff with experience of distressed debt then there may be an opportunity for them. In particular there may be an opportunity for European investment banks, which are, arguably, best placed to analyse and evaluate European distressed assets.

Question 6: What are the main concerns linked to each of these investor types?

There is a concern that moving NPLs from the banking sector to another part of the financial system may not by itself improve loss absorption but merely shift the losses elsewhere. This is linked to the problem of moral hazard, where investors do not have sufficient transparency of the assets in the NPL portfolio and so are not able to properly assess or price the portfolio. In particular, if banks decide to keep some NPLs on their balance sheet and dispose of them themselves, then the assets that they are trying to shift from their balance sheet are likely to be the ones of that are of lower quality or more likely to result in losses, thus exacerbating the issue.

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7. What are potential benefits and risks from a public policy point of view when considering the appropriate legal framework for secondary markets for loans, and especially NPLs?

[Please rank the following dimensions (in order of importance):]

1. promoting increased market size and depth and equal treatment of investors
2. debtor protection
3. privacy
4. data secrecy

We would add that there are some dimensions missing from the above list. In particular, we are concerned with the inclusion of equal treatment of investors: appropriate investor protection must be a key priority. Not all investors are equal and should therefore not be treated as such. In this context we would echo our comments in response to question 3 in that NPLs should not be sold or marketed to non-institutional investors.

We also believe that protection of public funds should also be a consideration of any legal framework related to NPLs. Tax-payer money should not be used to support the disposal of NPLs.

On the issues of privacy and data secrecy, we believe that our suggestion to use limited auctions of the NPLs would restrict the number of people privy to the information on the NPLs and may support transparency while still protecting privacy and data secrecy.

Question 9: Do differences in these benefits and risks across Member States justify national differences in the framework for secondary markets for loans? If yes, in which way?

No, we would not support differences in the framework as this may lead to regulatory arbitrage. Additionally, differences across Member States would not support the objectives of building a capital markets union. We would also be concerned that allowing differences across jurisdictions may place tax-payer money at stake as different Member States may have difference appetites for providing government support to their banks.

Question 11: What is the most suitable manner to protect a debtor in the case of transfer of a loan and/or collateral by the creditor to a third party?

Legal protection of property rights should be maintained at all times and in a way that is consistent with applicable law and judicial practice. We are therefore strongly in favour of harmonising the respective legal regimes across Member States and would welcome efforts to ensure that the judicial process can be relied upon in all Member States to be equitable, transparent, efficient and effective. We are, for the same reasons, sceptical about pursuing extra-judicial processes instead of addressing existing shortcomings (see. sec. I.3 and sec. II

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below). The most suitable manner to protect a debtor is to not sell his debt to a debt collector firm.

See our response under question 19.

Question 12: What are the (potential) advantages from specialisation across jurisdictions or asset classes?

We believe that homogeneity in a portfolio is a key feature of making it an attractive investment option therefore specialisation by asset class or jurisdiction may be an advantage. Specialisation by jurisdiction, for example, would allow investors with local expertise to more easily invest in the portfolio.

Question 13: Are you aware of obstacles to operating in secondary markets across national jurisdictions? Would you consider these obstacles to be significant, and/or influence your geographical scope of business operations?

We believe there is an issue with the lack of harmonisation in insolvency law across Member States. A lack of knowledge of local insolvency law may discourage investors from investing cross-border as they may be concerned about the processes for recovering collateral. Without a clear picture of the situation in a Member State, the investor is will not be able to assess, for example, how long it may take to recover the collateral. This means that they will not be able to fully assess all risks associated with the NPL portfolio and therefore may be discouraged from investing.

Question 14: Do you consider that an EU regulatory framework (Directive or Regulation) regulating certain aspects of the transfer of loans would be useful? What are in your view the key elements that should be addressed in such a framework?

We believe the focus should rather be on ensuring that the implementation of national law works effectively and efficiently. We believe that harmonisation of the existing framework, particularly in the area of insolvency would be a more useful initiative.

Question 16: What are the advantages of having access to third-party loan servicers in terms of secondary loan market efficiency?

In particular, do you see specific advantages for
- helping banks overcome legacy assets;
- creating investment opportunities for specialised investors?

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Third-party loan servicers may cater to those institutions who do not wish to move their NPLs off their balance sheet. These service providers who have the expertise in handling NPLs may be able to provide support to banks who currently lack this expertise. However, it should be noted that bringing in a third-party loan servicer adds another stakeholder to the value change, and may change the distribution of incentives. Therefore, in principle we see some merit in these third-party providers, but recognise the following issues:

- Third-party providers may have different incentives to the banks they service. In general, these firms act for a fee received from the bank. If this fee has no element linked to the final profit made from the NPLs, or indeed linked to a successful removal of the NPLs, then these companies are not incentivised to seek a positive outcome – or may settle for a less profitable one. Conversely, agents who are remunerated predominantly by way of success fees may be incentivised to optimise recovery results under all circumstances, which may lead to excessive pressure on creditors.
- There is a potential reputational risk when the third-party loan servicers seek to cease collateral. If the third-party servicer seeks to seize the collateral, the bank are able to "hide" behind the third-party and any tactics they may use. In this case, the bank is able to avoid any responsibility for this because the use of a third-party acts as a smokescreen. There is also a legal element to consider; if the third-party acts in a way which leads to legal redress the bank can again distance themselves from this as they can claim they were not acting directly – there is an element of "plausible deniability" in relation to the actions of the third-party.
- Finally, the use of third-party service providers may disincentivise a quick disposal of the NPLs.

Question 19: What are the main risks for debtor protection, in particular for the households in financial difficulties, which are linked (directly or indirectly) with the practices of the third-party loan servicers?

In our response we assume that third-party loan servicers are debt collection agency and third parties who do not themselves take on ownership of the NPLs. We would also like to reiterate that distressed debt portfolios should only be sold to entities that themselves are regulated under EU or third country regulations.

As mentioned above, the use of third-party service providers allows banks to distance themselves from the methods and practices used to recover the collateral from debtors. In this case the tactics and methods employed by third-party service providers may be more aggressive than those that would be pursued by the bank itself.

Third-party loan servicers argue they are more efficient than a bank or a utility to recover debts, and that their success is not due to heavy-handed practices but rather a sophisticated analysis of borrowers' ability to pay. However, there is evidence of poor practices, harassment

and intimidation practices, including from debtors who report pressure to make unaffordable repayments. The sector is not adequately regulated in all Member States and regulation has frequently proven inadequate. We would also be wary of qualifying third-party loan servicers as fit and proper acquirors of distressed debt portfolios unless the purchase is effected through a regulated, adequately supervised entity.

Question 23: Do you consider that a EU regulatory framework (Directive or Regulation) regulating third-party loan servicers would be useful? If yes, should such legal framework include rules on - the licensing requirements for such servicers; - the supervision of such servicers? Are there any other elements that should be covered by such a legal framework?

In order to address our concerns outlined above, it may be appropriate to develop a regulatory framework that addresses the remuneration structures of these firms in order to ensure that their incentives are more closely aligned with that of the banks.

Question 25: Are you aware of significant differences in business practices in different markets and jurisdictions, for example through voluntary codes of conducts, industry standards, etc.? If yes, does this, and how, constitute an obstacle to your business?

Where these codes of conduct etc are designed to protect debtors, for example in the case of the UK's debt collection guidance, then we would support them and consider that they should not be seen as an unnecessary obstacle.

Question 27: In the markets and jurisdictions that are relevant to you, are there unduly onerous legal restrictions in place:

a. on the sale of loan portfolios, including to non-bank entities? Please specify these restrictions and their impact.

b. on banks that want to outsource some or all loan servicing functions to third parties, including to non-bank entities. Please specify those restrictions and their impact. Such undue restrictions could for example concern the areas of debtor protection, privacy, data secrecy, equal treatment of investors. If yes, could the removal of such undue requirements be considered? Please specify where such an approach could be contemplated and describe the advantages and drawbacks thereof.

We would like to express our disappointment with the drafting of this question and the obviously leading language used in it. If the restrictions in place in Member States are unduly onerous, and therefore illegal, then the correct response is legal redress. If, instead, the

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Commission wished to explore the impacts of legal restrictions in Member States then the question should have been phrased in a neutral way, in order not to lead the responses given.

Question 28: What specific aspects could be improved, in order to facilitate existing cross-border activities and/or entry into new markets? Going beyond mere facilitating, what would accelerate the resolution of NPLs?

We believe the ECB's recently published guidance to banks on NPLs contains a useful strategy to the management of NPLs.

Aside from this we would also like to highlight our previous comments on harmonisation of Member States' national insolvency laws. Greater harmonisation would facilitate greater certainty for investors across jurisdictions which may help provide assurance and increase the likelihood that investors would consider a cross-border investment. While there is uncertainty about, for example, the processes for collecting collateral investors may be disincentivised from taking on portfolios from other jurisdictions.

We also would like to highlight that the development of fund managers who may be investors in distressed debt is also dependent on a range of factors, including the availability of qualified and experienced fund managers and the tax treatment of funds in different Member States.

Differences in taxation may lead to an obstacle to a fully integrated European market for funds and fund managers and may hamper cross-border investment. We would support further work examining these issues, with a view towards improving the market for NPLs.

Question 29: Do you consider that the development of a common EU approach would have an added value in the areas of:

a. the sale and transfer of loans?

b. loan servicing by third parties? If yes, which areas so far regulated under national law should be the focus of such harmonisation efforts? Potential focal points could include third party servicers' licensing regimes, capital requirements, trade secrecy and consumer protection. Are there other actions that could be taken at EU level that would yield significant benefits for market efficiency (for example EU guidance or recommendations, the creation of a central register of loan servicers, etc.)?

Yes, in the manner outlined above, that is:

- Harmonisation of insolvency law and practices;
- Rules on the remuneration of third-party loan servicers;

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- Further harmonisation of rules to create a level playing field and facilitate the establishment, passporting, funding and management of funds for distressed debt in different Member States.
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Question 34: Do you agree with the possible main features of an accelerated loan security as described above? If not, what are the features that you do not agree with and why?

We would caution against the development of an instrument which is designed to be used in all jurisdictions, and in particular in jurisdictions where the judicial process for recovering collateral is inadequate. This is because the function of the accelerated loan security appears to be to empower the administrative branch to intervene where the judicial branch is failing. This may interfere with the separation of powers in Member States. Additionally, we would caution that in situations where the judicial process is failing, the administrative process may also be subject to some problems.

Additionally, while we welcome the carve outs proposed by the Commission in relation to social equity considerations, in particular with regards to residential properties that are familial dwellings, we have concerns that the list of exemptions is not well defined. We consider that if an instrument requires so many exemptions it may not be an appropriate tool.

Finally, we are concerned that the accelerated loan security may impinge on national contract law, over which the Commission does not have jurisdiction. Although the accelerated loan security may be designed only to apply to a limit number of contracts in a Member State, in specific circumstances, we are still uncomfortable with this interaction. In particular, the enforcement of contracts is an issue of civil law, not administrative law. Instead of the creation of an instrument to address failings in the judicial system, efforts would be better focussed on ensuring a more harmonised insolvency framework.

Question 36: Do you agree with the proposed restriction on the scope of a possible accelerated loan security instrument to loans to businesses and corporates, and on the exclusion of primary residence of borrower even in the case of these loans? Please explain the reasons for your answer.

Please see our response to question 34.

Question 37: In what ways could an accelerated loan security be rendered potentially advantageous to borrowers to ensure its willing take-up by debtors (e.g. possible discharge of debtors in case the value of the assets becomes less than the debt)?

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Although in principle we support measures taken to make the accelerated loan security advantageous to debtors, we are concerned that the approach outlined in the question would simply lead to the banks over-collateralising on loans in order to protect against the case where the assets becoming less than the debt owed.

We also echo our comments in response to question 34 on our concerns about the overall structure of the accelerated loan security.

Question 38: How should an accelerated loan security instrument be designed in order to be consistent with the preventive restructuring framework and the insolvency law of your country (e.g. stay on enforcement actions, cram-down on minority creditors, avoidance actions, ranking of creditors)? In your view, what would be the main obstacles to ensure such consistency?

As far as households are concerned, we do not feel this is the right approach. When consumers can no longer pay off their debts due to a decline or loss of income all their debts are affected, not only the outstanding loan(s). For this reason, many countries have set up debt-resolution procedures that include all the debts of the households concerned. If an accelerated procedure is granted to lenders only, it will be difficult for other creditors to agree to negotiate a debt resolution plan.

Equally, we would like to highlight that many SME creditors are as dependent as households on the very assets they have provided as collateral. We do not believe that the proposed accelerated loan security instrument is an appropriate way of balancing their fundamental rights and needs against the interest of creditors. As mentioned previously, there is a risk that the inadequacies of the legal system are solved in a way that only inflicts further damage on the rule of law and the credibility of the State in countries where institutional deficiencies are already at the root of the problems that these measures are seeking to solve.

We are very doubtful of any regime that compromises the ability of borrowers to take legal action and would call upon the European legislators to step up their efforts to guarantee reliable, equitable and effective of judicial insolvency procedures across the EU.

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