EUROPEAN
COMMISSION

Brussels, 14.3.2018
SWD(2018) 76 final

PART 2/2

COMMISSION STAFF WORKING DOCUMENT

EXECUTIVE SUMMARY OF THE 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) 75 final}

Executive Summary Sheet

Impact assessment on accelerated extrajudicial collateral enforcement (AECE) for secured loans to companies and entrepreneurs

A. Need for action

Why? What is the problem being addressed?

High levels of non-performing loans (NPLs) 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. To further address the challenges of high NPLs in Europe, the "Action Plan To Tackle Non-Performing Loans in Europe" by the European Council calls upon various institutions to take appropriate measures. In particular, in order to reduce the risk of new NPL problems arising in the future, one of the key policy areas is to enable banks to recover effectively and swiftly collateral value when borrowers' default on secured loans. As a matter of fact, when procedures for enforcing collateral are lengthy and costly, the microeconomic benefits of the use of collateral are impaired (ex-ante banks tend to lend less and/or at higher lending rates and ex-post banks accumulate on their books a large stock of bad loans for which recovery of value from collateral is difficult). The enforcement procedures in the EU are usually of judicial nature. However, the inefficiencies of the court systems constitute a challenge for NPL resolution in some Member States, mainly owing to the excessive length of proceedings. This is sometimes also due to the clogging-up of the courts and practically results in lower recovered amount for secured creditors. Extra-judicial mechanisms to enforce collateral as alternative faster and cheaper ways to in-court proceedings are available in some but not in all Member States. Out-of-court procedures are very heterogeneous across Member States, with a wide variety in terms of approaches, scope and efficiency, hence negatively affecting the level-playing field of banks and business borrowers alike.

What is this initiative expected to achieve?

This initiative which is part of a broader package of measures to tackle the issue of Non-performing loans aims at: (i) ensuring that banks in all Member States have at their disposal out-of-court enforcement procedures for collateral and at (ii) enhancing the effectiveness of existing national mechanisms by providing secured creditors with an efficient tool to recover more value and in a swift manner in case of business borrowers' default. This would benefit banks by preventing the future accumulation of high level of NPLs on their balance sheet. By strengthening the ability of banks to recover value swiftly and in a consistent manner across the Member States, this initiative should enable banks to grant more loans to businesses, in particular SMEs. A minimum set of harmonised features for out-of-court procedures would ensure a level-playing field for banks in all Member States including making more credit available cross-border. Finally by allowing third party investors to also benefit from out-of-court enforcement in case of NPLs portfolio disposal, it would have a positive impact on the NPLs secondary market. It would facilitate price discovery, transactions and greater liquidity in loans markets for pan-European investors who will be able to operate under similar conditions across the EU through economies of scale.

What is the value added of action at the EU level?

Without policy intervention, the divergence between countries in their banking system's ability to manage NPLs for the benefit of greater access to finance will not be addressed and might continue to widen. Only those banks operating in the Member States where fast and efficient out-of-court enforcement mechanisms exist will have appropriate tools to alleviate the future accumulation of NPLs. Hence, Member States where those mechanisms do not exist or are not properly functioning will run the risk of seeing lending to corporates being curtailed or made more expensive, as the last financial crisis has shown in some Member States. Banks operating cross-border will continue to face fragmented collateral enforcement frameworks and will need to assess the features of different legal systems, which leads to unnecessary costs and constitutes a barrier to cross-border lending in the Single Market. The value added of action at EU level would be to increase the level-playing field for banks and business borrowers alike, and to the scale-up the secondary market for NPLs through economies of scale. This would benefit the whole EU as it will reduce spill-over effects whereby - given the high level of financial system interconnectedness within the EU (and especially Eurozone) - NPL problems in one Member State negatively affect lending and the economy in other Member States.

B. Solutions

What legislative and non-legislative policy options have been considered? Is there a preferred choice or not? Why?

The Impact Assessment has considered the following policy options (on top of the baseline scenario i.e. no EU action):

- Option 1 - Non-regulatory action based on existing international harmonisation initiatives of extrajudicial collateral enforcement procedures (Tool: Recommendation)
- Option 2 - Minimum harmonisation of extrajudicial collateral enforcement procedures (Tool: Directive)
- Option 3 - Creation of a new EU security right together with a fully harmonised extrajudicial enforcement procedure (Tool: Regulation)

Upon evaluation and consideration of the impacts, option 2 was found to be preferable because it achieves the policy objectives while maximising the benefit/cost ratio. Option 2 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 with Member States' private and public laws. As a result, Option 2 is considered the most proportionate among the three options considered.

Who supports which option?

Option 3 has been opposed by the whole stakeholders' spectrum (with very few exceptions) mainly given that establishing a new EU security right would be too complex and interfere too much with national legal systems, i.e. civil law, transfer of ownership, publicity requirements, insolvency, including the ranking of creditors in insolvency, and public laws.

Option 2 was supported the most by the banking industry, third party investors and some Member States which see benefits in the establishment of a common set of features which would govern out-of-court enforcement procedures across the EU. However, some stakeholders expressed some reservations as regards the interaction of the mechanism with restructuring and insolvency procedures (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. Business associations, just like some Member States, argued that a new framework would have more value added 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.

Option 1 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 such systems. However, few stakeholders indicated this option as a possible way forward.

C. Impacts of the preferred option

What are the benefits of the preferred option (if any, otherwise main ones)?

The primary function of security/collateral is the reduction of the risk of losses of a credit provider with respect to the performance of a debt, i.e. the repayment of the loan by the borrower. The degree to which a secured transactions law can perform a risk-reducing function is mainly dependent on the legal efficiency of the security interest provided under a national law and the value of collateral upon enforcement. Option 2 is expected to improve the efficiency of out-of-court collateral mechanisms across the EU by improving both aspects hence reducing the risk of a creditor's losses. This is clearly a benefit from the point of view of creditors: the recovery rates under option 2 are expected to indeed increase on average in the EU to 78% from the current estimate level of 68% (as per World Bank – Doing Business data). In a stylised future recession with a hypothetical gross amount of new NPLs of EUR463bl, this would translate into higher recovery amount of EUR8bl i.e. 2.3% compared to the baseline scenario. Improving the efficiency of out-of-court collateral mechanisms in the EU would also lead to a number of economic benefits for the debtor, in particular a higher supply of credit and better pricing conditions. The reduction in borrowing costs for companies would be, according to a conservative estimation of 10 basis points of lending rates i.e. long term annual savings for borrowers of more than EUR500M.

What are the costs of the preferred option (if any, otherwise main ones)?

As the preferred option lays a framework on out-of-court enforcement procedures, costs associated with such procedures would mainly be borne by banks/secured creditors and companies, and not by the taxpayers like this is the case for judicial enforcements of collateral. Costs which would be borne by private parties are not expected to be significant. There will be some costs for competent authorities which supervise banks in relation to the envisaged collection of information by the latter on the number of secured loans which are enforced out-of-court.

How will businesses, SMEs and micro-enterprises be affected?

SMEs depend on bank financing for their operations more than corporates as the latter can finance themselves more easily on the public capital markets by issuing bonds or raising equity financings. Since banks with an effective, expedited way to enforce their collateral can expect on their lending activities 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), they would revise downwards their lending rates. As a matter of fact, improvement of the recovery rates by 10 percent points is found to be, on average, associated with lower lending costs by 10 to 18 bps (with pricing effect stronger for small borrowers by about 40%). Moreover, given the reduction of risks explained above (especially the lower loss given default) it is expected that more projects which were not able to get financing previously could obtain bank loans. As a result, secured lending and overall the supply of finance is expected to also increase for those SMEs that have assets to post as collateral.

Will there be significant impacts on national budgets and administrations?

Significant impacts on national budgets and administrations are not expected. If anything, out-of-court mechanisms would decrease the 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. Moreover the increased use of out-of-court mechanisms (when not challenged) would reduce the cases that require the intervention of courts hence freeing up their capacity.

Will there be other significant impacts?

Given the potential negative social impact in case AECE is applied too widely, 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). Consumer 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.

Moreover, option 2 is expected to have an overall positive influence upon employment and entrepreneurship because it would facilitate access to finance for companies and entrepreneurs. However in certain cases (for example when the collateral is the main machinery of the business) the out-of-court enforcement could lead to making it impossible for that company/entrepreneur to continue performing its activities and this could lead to the company/entrepreneur having to lay off employees. The ability of a company or entrepreneur to request the judicial court to open a restructuring 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 workers' rights under existing legislation.

D. Follow up

When will the policy be reviewed?

Five years after the date of application of the Directive, the Commission shall carry out an evaluation of this initiative. The objective of the evaluation will be to assess, among other things, how effective and efficient the measure has been in terms of achieving the objectives presented in this impact assessment and to decide whether new measures or amendments are needed.