

Brussels, 14.3.2018  
SWD(2018) 75 final

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

<b>AECE</b>	Accelerated Extrajudicial Collateral Enforcement
<b>ALS</b>	Accelerated Loan Security
<b>AMC</b>	Asset Management Companies
<b>CMU</b>	Capital Markets Union
<b>DCFR</b>	Draft Common Frame of Reference
<b>EA</b>	Euro Area
<b>EBA</b>	European Banking Authority
<b>EBRD</b>	European Bank for Reconstruction and Development
<b>EFSIR</b>	European Financial Stability and Integration Review
<b>EP</b>	European Parliament
<b>ESRB</b>	European Systemic Risk Board
<b>FCD</b>	Financial Collateral Directive
<b>FSC</b>	Financial Services Committee
<b>GDP</b>	Gross Domestic Product
<b>IMF</b>	International Monetary Fund
<b>MFI</b>	Monetary Financial Institutions
<b>MLTS</b>	Model Law on Secured Transactions
<b>MS</b>	Member States
<b>NCA</b>	National Competent Authority
<b>NFC</b>	Non-Financial Company
<b>NPE</b>	Non-Performing Exposure
<b>NPL</b>	Non-Performing Loan
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>RAQ</b>	Risk Assessment Questionnaire
<b>SME</b>	Small and medium-sized enterprise
<b>SSM</b>	Single Supervisory Mechanism
<b>TFEU</b>	Treaty on the Functioning of the European Union
<b>UNCITRAL</b>	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).<sup>1</sup> 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)<sup>2</sup>. 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.<sup>3</sup>

High NPL ratios<sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup> 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<sup>7</sup>, 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.<sup>8</sup> 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

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

<sup>2</sup> 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.

<sup>3</sup> 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".

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

<sup>5</sup> 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.

<sup>6</sup> 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.

<sup>7</sup> As also underlined in the European Semester recommendations to relevant Member States.

<sup>8</sup> See ESRB (2017) and IMF (2015).

growth. This analysis is shared by a number of reports from European institutions, international organisations, and think tanks.<sup>9</sup>

## 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<sup>10</sup> and the total volume of NPLs across the EU is still at the level of EUR 950 billion.<sup>11</sup>

Figure 1 EU Non-Performing Loans ratio

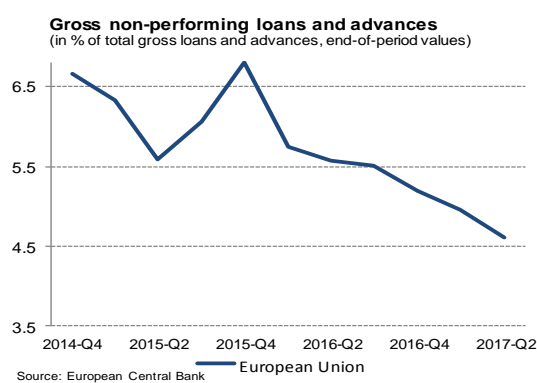
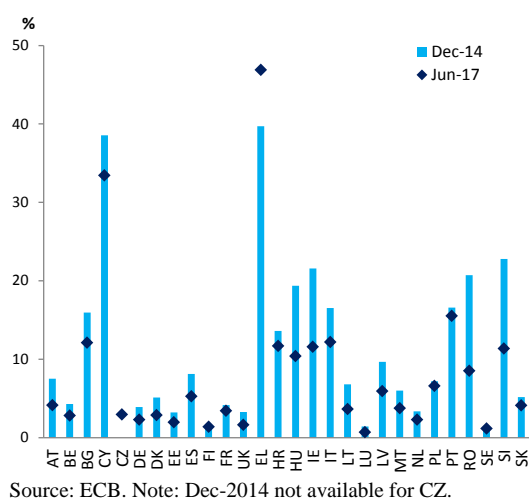


Figure 2: NPL ratio in EU Member States



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.

<sup>9</sup> 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).

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

<sup>11</sup> 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.<sup>12</sup> 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.<sup>13</sup>

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.<sup>14</sup>
- 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

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

<sup>13</sup> COM(2017) 592 final, 11.10.2017, available at: [http://ec.europa.eu/finance/docs/law/171011-communication-banking-union\\_en.pdf](http://ec.europa.eu/finance/docs/law/171011-communication-banking-union_en.pdf).

<sup>14</sup> 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.

<sup>15</sup>

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.

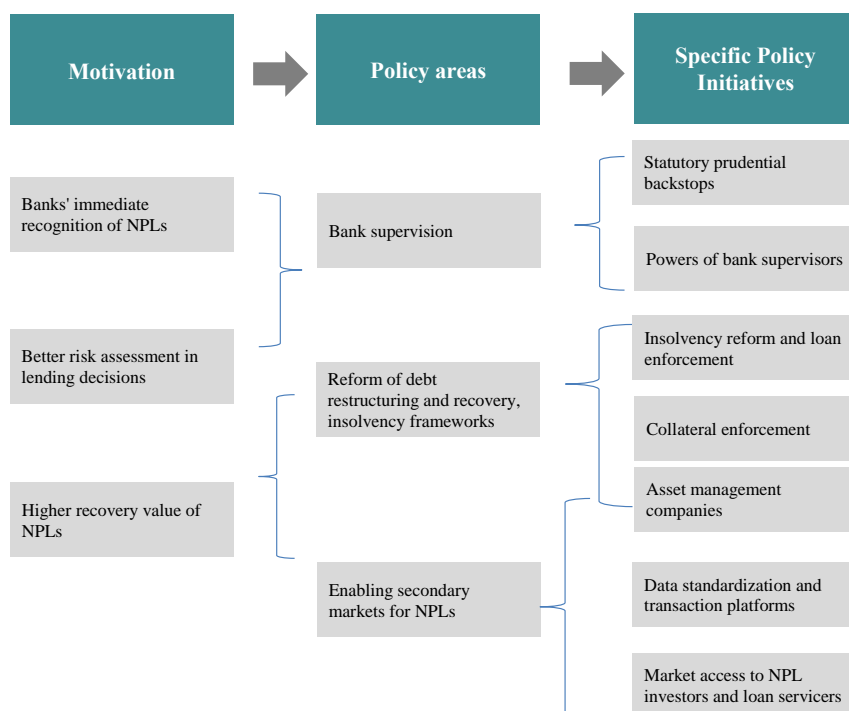
## **4 Commonalities and interdependencies of the various measures**

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**

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<sup>15</sup> 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.

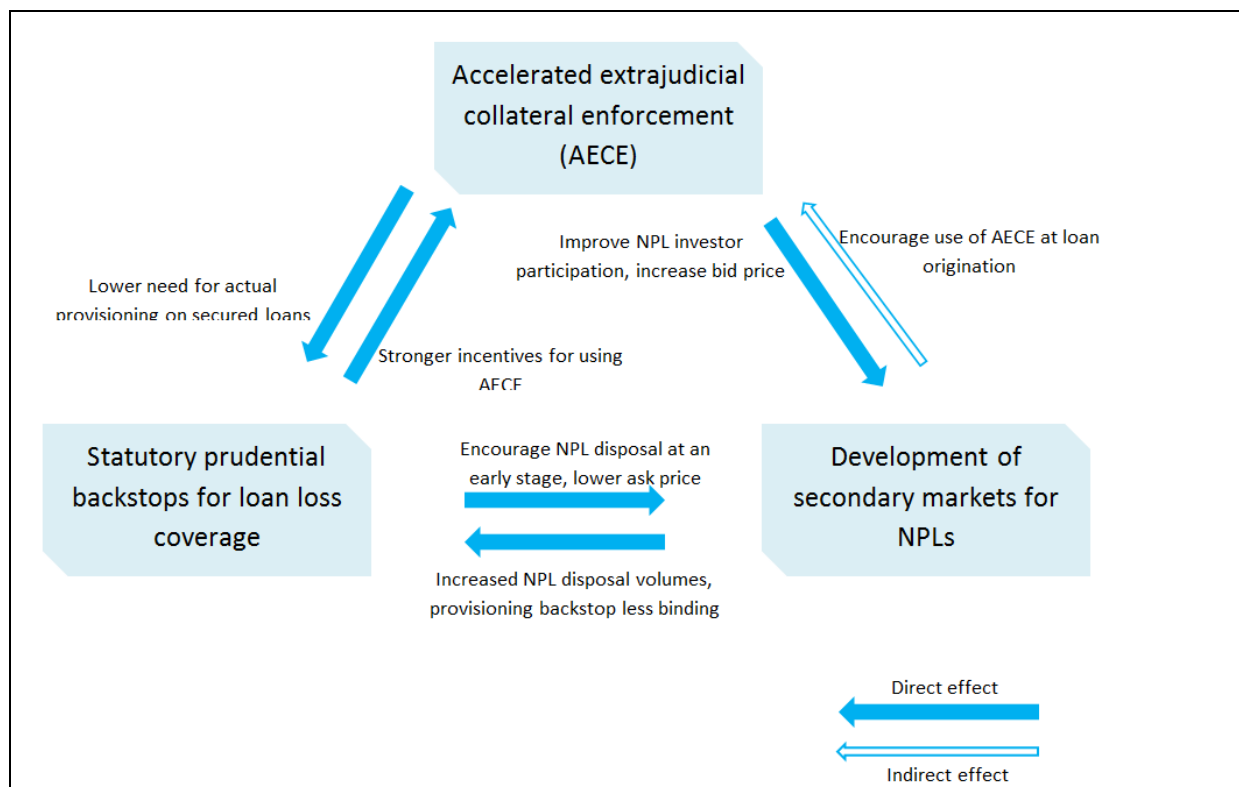


The Commission's three legislative initiatives, namely i) statutory prudential backstops for loan loss coverage; ii) the development of secondary markets for NPLs, and iii) accelerated extrajudicial collateral enforcement mechanisms, mutually reinforce each other and also interact with the other measures 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.<sup>16</sup>

## 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<sup>17</sup>.

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

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<sup>16</sup> COM(2016) 723 final.

<sup>17</sup> 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)<sup>18</sup>;
- (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<sup>19</sup>) by increasing the recoverable value of collateral and improving NPLs secondary market liquidity; and

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<sup>18</sup> 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 interconnecteness 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.

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<sup>19</sup> 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.<sup>20</sup> 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**

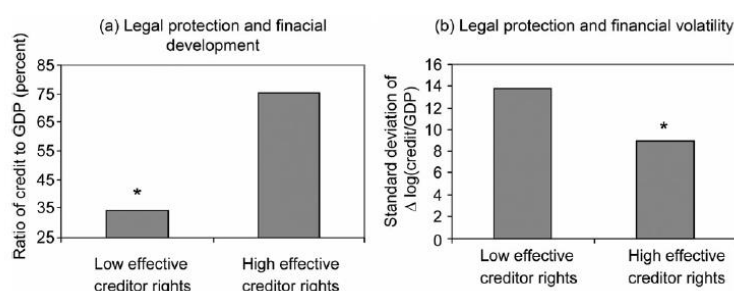
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<sup>20</sup><https://www.oecd.org/investment/toolkit/policyareas/investmentpolicy/contractenforcementanddisputeresolution.htm>



**also make credit markets more volatile i.e. more responsive to external shocks** (see Figure 5 below).<sup>21</sup> 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).<sup>22</sup> 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.<sup>23</sup>

*Figure 5 – Legal protection and financial development/volatility*



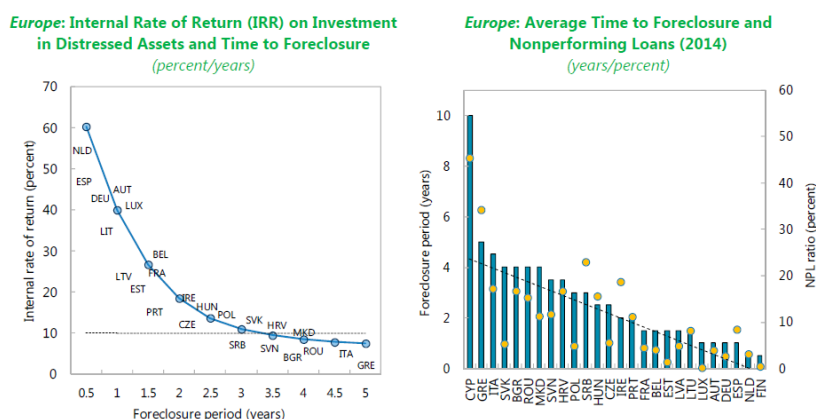
Source: Creditor Protection and Credit Response to Shocks; Note: Panel (a) shows how the development of credit markets (as measured by the ratio of credit to the private sector supplied by the financial sector to GDP) is strongly related to a measure of legal protection to creditors. Panel (b) shows 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.

<sup>21</sup> Galindo, Arturo José, and Alejandro Micco. 2007. “Creditor Protection and Credit Response to Shocks.” *World Bank Economic Review* 21 (3): 413–38.

<sup>22</sup> 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.

<sup>23</sup> 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<sup>24</sup>. 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<sup>25</sup> 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<sup>26</sup>.

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<sup>24</sup> Academic study: *Security Rights and the European Insolvency Regulation* - <http://f.wpengine.netdna-cdn.com/files/2014/07/SREIR-Roman-Legal-Systems.pdf>.

<sup>25</sup> Except for the judicial authority which is also possible under national laws.

<sup>26</sup> 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<sup>27</sup> (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<sup>28</sup> 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:

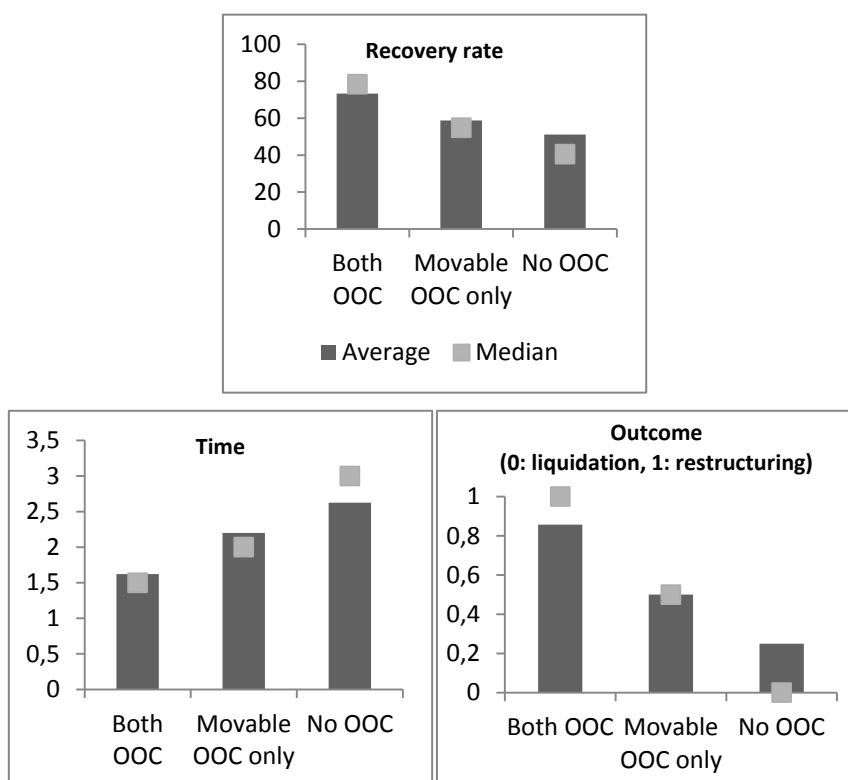
- Member States with out-of-court collateral enforcement mechanisms on both movable and immovable assets show the highest recovery rates, the lowest time to recovery, and the best outcome in terms of company preservation (i.e. restructuring instead of liquidation);
- The opposite could be said about 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.

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<sup>27</sup> ECB/SSM - Stocktake of national supervisory practices and legal frameworks related to NPLs – June 2017

<sup>28</sup> 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)<sup>29</sup>. 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<sup>30</sup> 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<sup>31</sup>.** The sharp rising

<sup>29</sup> <http://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A32008R0593>.

<sup>30</sup> 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

<sup>31</sup> 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)<sup>32</sup>. In Italy for example it takes 40 months for creditors to take possession of assets posted as collateral<sup>33</sup>.

**As revealed by a survey conducted by the SSM<sup>34</sup>, 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<sup>35</sup> conducted in 2015 on 19 countries including 9 euro area members<sup>36</sup> 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<sup>37</sup> 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.

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<sup>32</sup> Resolving non-performing loans in Europe – ESRB – July 2017.

<sup>33</sup> <http://www.italy24.ilsole24ore.com/art/markets/2016-05-04/padoan-192307.php?uuid=ADu9aj>.

<sup>34</sup> ECB - Stocktake of national supervisory practices and legal frameworks related to NPLs – June 2017.

<sup>35</sup> A Strategy for Resolving Europe's Problem Loans – Technical Background notes - September 2015.

<sup>36</sup> 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).

<sup>37</sup> 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<sup>38</sup> - 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<sup>39</sup> (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<sup>40</sup>, 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

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<sup>38</sup> 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).

<sup>39</sup> 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.

<sup>40</sup> <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<sup>41</sup>, 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

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<sup>41</sup> IMF Working Paper WP/16/134 – José Garrido



information asymmetries intrinsic to this kind of markets<sup>42</sup>. 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<sup>43</sup>. Long time to recover loans has hence a negative impact on the price of NPLs. A recent study<sup>44</sup> 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)***<sup>45</sup>

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.

<sup>42</sup> 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)

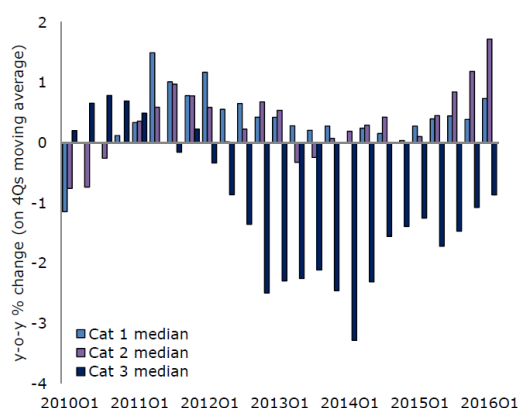
<sup>43</sup> Keynote speech by Vítor Constâncio, Vice-President of the ECB, at an event entitled "Tackling Europe's non-performing loans crisis: restructuring debt, reviving growth" organised by Bruegel, Brussels, 3 February 2017

<sup>44</sup> 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).

<sup>45</sup> 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<sup>46</sup> 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.

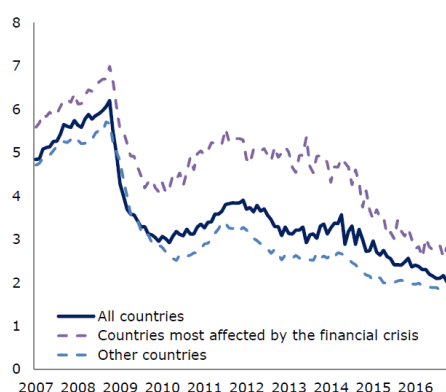
Moreover it is noteworthy that this decrease in lending seems to have taken place after the spike in NPL ratios (in 2012/2013) when banks had to build up their provisioning in reaction to an increase in nonperforming exposure in their loan book. In Category 2 Member States, lending to NFCs started to 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<sup>47</sup>. 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.

<sup>46</sup> The lending contraction for households over the same period never exceeded 1.5%.

<sup>47</sup> 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<sup>48</sup>.** 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<sup>49</sup>:

<sup>48</sup> Resolving non-performing loans in Europe – July 2017 – ESRB.

<sup>49</sup> 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<sup>50</sup>). 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<sup>51</sup>.

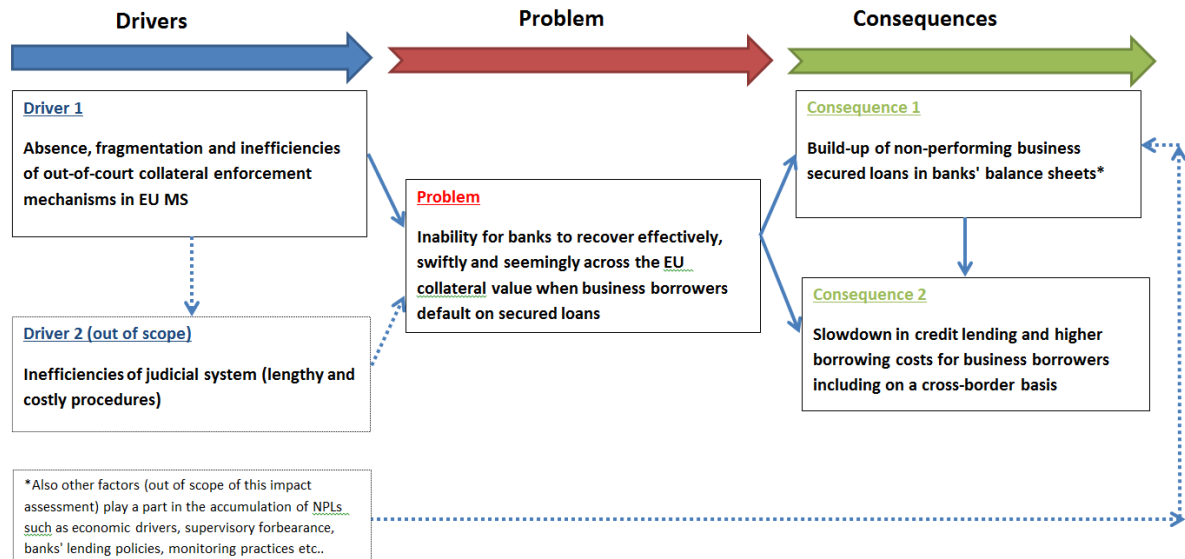
Finally, a deeply integrated area like the EU (and even more so within the euro area) could see important cross-border spill-overs of future NPL problems in some Member State on other Member States.

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<sup>50</sup> In case of renegotiation of some of the loans currently non-performing.

<sup>51</sup> 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<sup>52</sup>.

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,

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<sup>52</sup> 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<sup>53</sup> 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.

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<sup>53</sup> 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*

<b>Problem and consequences</b>	<b>General and specific objectives</b>
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)<sup>54</sup>, 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<sup>55</sup> 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

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<sup>54</sup> At credit origination, inclusion of the enforcement mechanism would require agreement by the counterparties, i.e. be voluntary. At a later stage, once the requirements for triggering the mechanism are met, the creditor would still have discretion as to whether or not trigger the mechanism.

<sup>55</sup> 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<sup>56</sup> (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*)<sup>57</sup> 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:

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<sup>56</sup> 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.

<sup>57</sup> 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<sup>58</sup> and the more recent 2016 UNCITRAL Model Law on Secured Transactions<sup>59</sup> discussing policy issues and containing recommendations including some useful suggestions on out-of-court enforcement of security rights<sup>60</sup> 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)<sup>61,62</sup>. It contains a section on "Extra-judicial enforcement"<sup>63</sup>.
- (iii) The European Bank for Reconstruction and Development (EBRD) *Model Law on Secured Transactions* (MLST)<sup>64</sup> aims at facilitating the transition to capital market economies and the introduction of efficient systems of security rights in Central and Eastern European Countries<sup>65</sup>. 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<sup>66</sup>;

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<sup>58</sup> UNCITRAL - art. 131-177; [https://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670\\_Ebook-Guide\\_09-04-10English.pdf](https://www.uncitral.org/pdf/english/texts/security-lg/e/09-82670_Ebook-Guide_09-04-10English.pdf), Chapter VIII, p. 310.

<sup>59</sup> [http://www.uncitral.org/pdf/english/texts/security/ML\\_ST\\_E\\_ebook.pdf](http://www.uncitral.org/pdf/english/texts/security/ML_ST_E_ebook.pdf)

<sup>60</sup> Chapter VIII, p. 310.

<sup>61</sup> Based in part on a revised version of the Principles of European Contract Law and published in 2009

<sup>62</sup> [http://ec.europa.eu/justice/contract/files/european-private-law\\_en.pdf](http://ec.europa.eu/justice/contract/files/european-private-law_en.pdf).

<sup>63</sup> [http://ec.europa.eu/justice/contract/files/european-private-law\\_en.pdf](http://ec.europa.eu/justice/contract/files/european-private-law_en.pdf), p. 4715.

<sup>64</sup> Published in 2004 and then in 2010

<sup>65</sup> 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.

<sup>66</sup> 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<sup>67</sup>;
- 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<sup>68</sup>;
- 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)<sup>69</sup>;

**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

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<sup>67</sup> Based on UNCITRAL Guide (art. 131-177)

<sup>68</sup> Based on DCFR (Book IX - 7:103)

<sup>69</sup> 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<sup>70</sup>, 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

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<sup>70</sup> 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 be 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<sup>71</sup>. 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)<sup>72</sup>, 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<sup>73</sup>.

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)<sup>74</sup>. The introduction of the AECE in the national framework would leave MS' national insolvency law unaffected<sup>75</sup>. 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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<sup>71</sup> [http://ec.europa.eu/information\\_society/newsroom/image/document/2016-48/proposal\\_40046.pdf](http://ec.europa.eu/information_society/newsroom/image/document/2016-48/proposal_40046.pdf)

<sup>72</sup> 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".

<sup>73</sup> Art 1, COM (2016) 723

<sup>74</sup> <http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A32015R0848>

<sup>75</sup> 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 uniformly 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 repossession of the assets would work as follows: once the debtor is in default in fulfilling 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 transferred to the bank/other creditor where the original loan has been transferred by a bank to a third party. 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. Concretely, 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 established following the valuation would impact how much the creditor would recover of its outstanding claim against 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 29<sup>th</sup> 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 29<sup>th</sup> 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 29<sup>th</sup> 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 29<sup>th</sup> 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 29<sup>th</sup> 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*

<b>Pros</b>	<b>Cons</b>
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*

<b>Impact on key stakeholders</b>	<b>Corporate (including SME) as borrowers</b>	<b>Secured creditors including investors</b>	<b>Other commercial creditors (unsecured, junior, suppliers, etc..)</b>	<b>Member states (competent authorities and public creditors)</b>
<b>Positive</b>	≈ /+ (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)		
<b>Negative</b>	≈ /- (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 <sup>76</sup> . The level of divergence is however lower compared to

<sup>76</sup> 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

<b>Impact on key stakeholders</b>	<b>Corporate (including SME) as borrowers</b>	<b>Secured creditors including investors</b>	<b>Other commercial creditors (unsecured, junior, suppliers, etc..)</b>	<b>Member states (competent authorities and public creditors)</b>
<b>Positive</b>	+ / + + (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)

<b>Negative</b>	- (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 <sup>77</sup> . 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 not 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.

<sup>77</sup> 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	+/-	<p>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.</p> <p>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.</p>
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.
<u>Consumer associations, NGOs, and private individuals</u>		No view provided
<u>Business associations</u>	+	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.
<u>The expert group</u>	++	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 ( <i>e.g.</i> 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*

<b>Impact on key stakeholders</b>	<b>Corporate (including SME) as borrowers</b>	<b>Secured creditors including investors</b>	<b>Other commercial creditors (unsecured, junior, suppliers, etc..)</b>	<b>Member states (competent authorities and public creditors)</b>
<b>Positive</b>	++ (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)
<b>Negative</b>	- (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*

<b>Stakeholders</b>	<b>View</b>	<b>Reason</b>
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.
<u>Consumer associations, NGOs and private individuals</u>	+/-	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.
<u>Business associations</u>		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.
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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
<b>Baseline</b>	<u>National</u> 1 - existing security rights	<u>National</u> - 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.	<u>National</u> - heterogeneous situation as national systems are applicable sometimes to consumers as well as business loans and different types of collateral (moveable/immoveable including primary residence)	<u>National</u> - heterogeneous situation as national systems have different features given the interlinks with private and public laws which differ between MS	<u>National</u> - different national rules	<u>National</u> - different national rules
<b>Option 1</b>	<u>National</u> 1 - existing security rights	<u>National</u> - 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	<u>National</u> - more homogeneity as MS recommended to exclude consumers and primary residence of business owners from the scope	<u>National</u> - more homogeneity as MS recommended to ensure that the procedural features comply with high level principles set at EU level	<u>National</u> - more homogeneity as MS recommended to ensure that the extrajudicial mechanism would be available to third parties in case of transfer of the loan	<u>National</u> - More homogeneity as MS will be recommended to inform other affected parties about out-of-court enforcement mechanism.
<b>Option 2</b>	<u>National</u> 1 -	<u>EU</u> - MS required to	<u>EU</u> - exclusion of	<u>EU</u> - high level	<u>EU</u> - requirement	<u>EU</u> - 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) <u>National</u> - 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  <u>National</u> - The modalities will be left to MS depending on the type of security AECE is attached to
<b>Option 3</b>	<u>EU</u> - creation of a new security right	<u>EU</u> - The repossession mechanism will be the attached to the new security right	<u>EU</u> - exclusion of consumers and primary residency of business owners from the scope	<u>EU</u> - repossession of assets upon default and asset valuation procedure via 3 <sup>rd</sup> party independent expert	<u>EU</u> - requirement to have the ALS available to 3 <sup>rd</sup> parties in case of the transfer of the loan	<u>EU</u> - 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		
<b>Baseline scenario</b> No policy change	0	0	0	0	0
<b>Option 1</b>	≈/+	≈/+	≈/+	+ / ++	≈
<b>Option 2</b>	+ / ++	+ / ++	+ / ++	+	+
<b>Option 3</b>	++	++	++	--	--

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*

<b>Option</b>	<b>Effectiveness/efficiency/coherence</b>	<b>Stakeholders support</b>	<b>Level of ambition/challenge</b>
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<sup>78</sup>:

- 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).

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<sup>78</sup>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<sup>79</sup> 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<sup>80</sup>;
- 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

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<sup>79</sup>Idem

<sup>80</sup> 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.

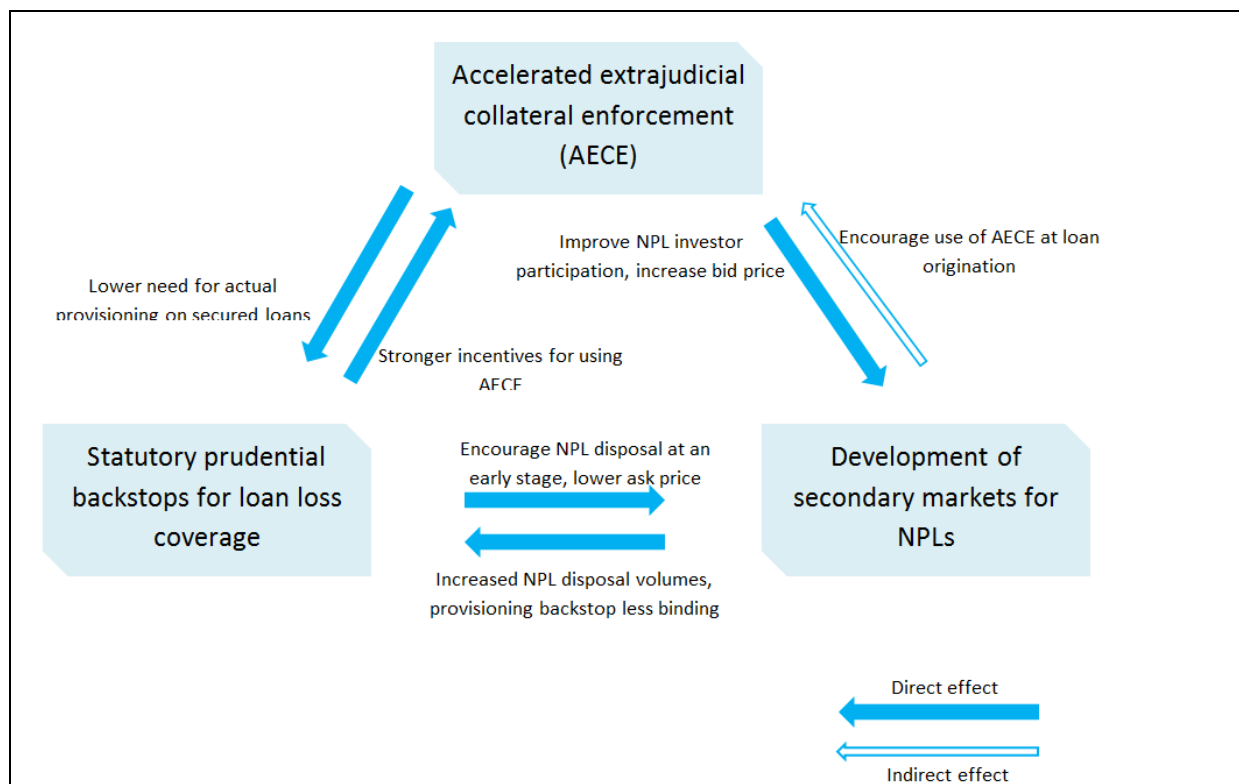
*Table 13 - Illustrative quantification of economic benefits*

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*

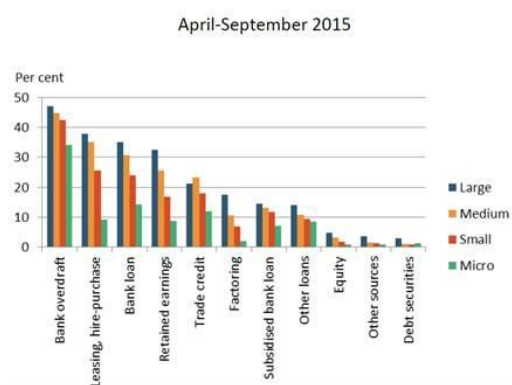
Improved investor participation and better functioning of secondary markets would reduce the bid-ask spread and increase the volume of NPLs that are transferred to third parties. Banks would dispose of NPLs more eagerly and at an earlier stage, therefore the *provisioning backstop* would be less often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

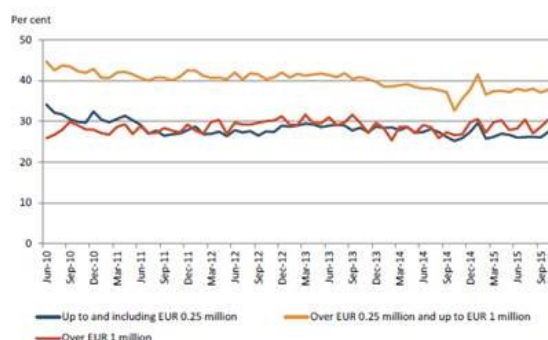
*Figure 11 – Type of funding according to firm size*



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<sup>81</sup>. 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 considered 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 a useful complement to judicial procedures by ensuring both parties an expeditious value recovering from unpaid loans in a timely and predictable manner.

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<sup>81</sup> 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)<sup>82</sup> 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<sup>83</sup>. 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.

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<sup>82</sup> See also Article 1 of Protocol 1 to the European Convention on Human Rights (ECHR).

<sup>83</sup> 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) <sup>84</sup>
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

<sup>84</sup> 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
<b>Total</b>	<b>25 YES / 3 NO</b>	<b>15 YES / 13 NO</b>	<b>24 YES / 4 NO</b>	<b>-</b>

### 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<sup>85</sup> includes an obligation for Member States to provide annual statistical data on inter alia: (i) the number of

<sup>85</sup> 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 ask 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)<sup>86</sup> and in the Commission Communication on the Banking Union (11.10.2017)<sup>87</sup>.

### **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 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.

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<sup>86</sup> CMU MTR Communication - [https://ec.europa.eu/info/sites/info/files/communication-cmu-mid-term-review-june2017\\_en.pdf](https://ec.europa.eu/info/sites/info/files/communication-cmu-mid-term-review-june2017_en.pdf)

<sup>87</sup> Banking Union Communication - [http://ec.europa.eu/finance/docs/law/171011-communication-banking-union\\_en.pdf](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<sup>88</sup>.
- **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

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<sup>88</sup> 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's argued that in certain MS one of the main obstacles to efficient enforcement of collateral are the privileges 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 a 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 than 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

<b><i>I. Overview of Benefits (total for all provisions) – Preferred Option</i></b>		
<b><i>Description</i></b>	<b><i>Amount</i></b>	<b><i>Comments</i></b>
<b><i>Direct benefits</i></b>		
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 <sup>89</sup> 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%).
<b><i>Indirect benefits</i></b>		

<sup>89</sup> 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	<u>Third party NPL investors</u>
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	<u>Banks</u>
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	<u>Administrations and indirectly taxpayers</u>

*Table 15 – overview of costs*

<b>II. Overview of costs – Preferred option</b>									
		Citizens/ Consumers		Businesses				Administrations	
		On e- off	Rec urre nt	One-off		Recurrent		One-off	Recurrent
				Banks	Debtor s	Banks	Debtor s		
<b>Introduction of AECE in loan contracts</b>	Direct costs	-	-	-		_90		_77	_77
	Indirect costs	-	-	EUR 4,167 – 12,500 per bank <sup>91</sup>	-	-	-	-	-
<b>Publicity of AECE</b>	Direct costs	-	-	EUR 4,167 – 12,500 per bank <sup>92</sup>	-	-	_93	-	-
	Indirect costs	-	-	-	-	-	-	EUR 3,000 – 9,000 per register <sup>94</sup>	-

<sup>90</sup> Due the well-developed supervisory framework for MFI, the envisaged change in contract could be complied with and supervised without additional costs.

<sup>91</sup> 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.

<sup>92</sup> 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.

<sup>93</sup> It is envisaged that the publicity costs borne by the creditor will remain unchanged.

<sup>94</sup> 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.<sup>95</sup>

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

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<sup>95</sup>. 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.<sup>96</sup> 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<sup>97</sup>). On the Outcome, we assume that Option 1 would only achieve partial convergence to the benchmark Outcome (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*

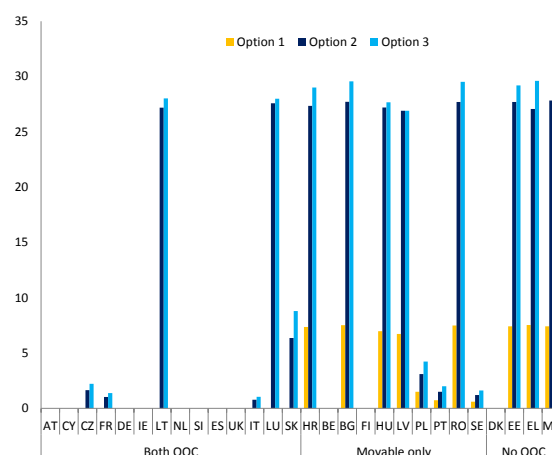
	<b>Option 1</b>	<b>Option 2</b>	<b>Option 3</b>
Gap closure of Time to recovery to benchmark	25%	50%	67%
Gap closure of Outcome to benchmark	25%	Full	Full
Which MS converge	Only MS that do not have OOC for both movable and immovable	All MS below benchmark	All MS below benchmark

<sup>96</sup> 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.

<sup>97</sup> 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.<sup>98</sup> 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.

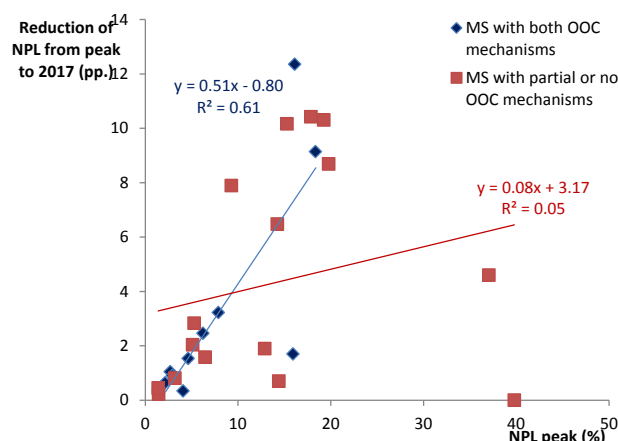
### Quantification of the impact under a stylised future NPL scenario

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.

<sup>98</sup> 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.<sup>99</sup>
- 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<sup>100</sup>, 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.

<sup>99</sup> 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.

<sup>100</sup> 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 points 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 <sup>§</sup>	0.0285
Beta	6.996***
Missing bid-ask <sup>§</sup>	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*** (0.00)	0.232*** (0.00)	0.229*** (0.00)	0.340*** (0.00)	0.278*** (0.00)	0.279** (0.04)
3-month rate	0.798*** (0.00)	0.689*** (0.00)	0.689*** (0.01)	0.410*** (0.00)	0.543*** (0.00)	0.543** (0.02)
Recovery rate	-0.011*** (0.00)	-0.014*** (0.00)	-0.014* (0.09)	-0.010*** (0.00)	-0.009 (0.23)	-0.008 (0.45)
Constant	3.822*** (0.00)	4.390*** (0.00)	4.354*** (0.01)	2.608*** (0.00)	2.752*** (0.00)	2.608** (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	<i>Fiducie, hypothèque and cession des créances professionnelles dite "cession Dailly</i> . Pacte comissoire 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.
<b>Total</b>	<b>15 YES / 13 NO</b>	<b>24 YES / 4 NO</b>	

## 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)

Righ 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.

#### Any other relevant information

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"<sup>101</sup>.

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.

### Type of enforcement procedure

- Appropriation in the case of Fiducie.
- creditor becomes the owner of collateral automatically upon borrower's default.

### Procedural steps

The *pacte comissoire* 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.

## **Germany**

*Source of information: Government response to public consultation, internal analysis and K&L Gates*

### Scope (contractual parties of the loan)

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.

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<sup>101</sup> 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 immovable 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 collateral.

### 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<sup>102</sup>. 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

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<sup>102</sup> <http://www.notar.sk/%C3%9A%20v%20Not%C3%A1rsk%C3%A1%20registr%C3%A1cia/Dobrovo%C4%BEn%C3%A9%20dra%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.

#### Any other relevant information

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.

Any other relevant information

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.

Average time and costs for out-of-court collateral enforcement (if available)

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<sup>103</sup> 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<sup>104</sup>:

- 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<sup>105</sup> 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

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<sup>103</sup> 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.

<sup>104</sup> 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).

<sup>105</sup> 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<sup>106</sup>:

- Increased reputational risk for banks which arises from the enforcement of collateral through an out-of-court mechanism.

Other commercial creditors (unsecured creditors, junior creditors, suppliers, etc..)

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:

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<sup>106</sup> 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)<sup>107</sup>. 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

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<sup>107</sup> 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<sup>108</sup>. 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<sup>109</sup> 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<sup>110</sup>:

- 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<sup>111</sup> 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 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

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<sup>109</sup> 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.

<sup>110</sup> 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).

<sup>111</sup> 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<sup>112</sup>:

- Increased reputational risk for banks which arises from the enforcement of collateral through an out-of-court mechanism

Other commercial creditors (unsecured creditors, junior creditors, suppliers, etc.)

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<sup>112</sup> 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.

#### 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)<sup>113</sup>. 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:

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<sup>113</sup> 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 not 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<sup>114</sup>. 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.

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<sup>114</sup> 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 swiftly 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 numerous 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**

#### Corporate (including entrepreneurs and SME) as borrowers

Positive direct<sup>115</sup> 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

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<sup>115</sup> 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<sup>116</sup>.

Negative direct impacts<sup>117</sup>:

- 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<sup>118</sup> 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

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<sup>116</sup> This is net of a possible increase in basis points that reflect the increased costs of the implementation of a new security right

<sup>117</sup> 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).

<sup>118</sup> 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<sup>119</sup>:

- 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

#### Other commercial creditors (unsecured creditors, junior creditors, suppliers, etc..)

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

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<sup>119</sup> 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.

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)<sup>120</sup>. 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<sup>121</sup>, 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

<sup>120</sup> The possible decrease of court cases would also depend on the number of appeals against the out-of-court enforcement procedures.

<sup>121</sup> 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	<ul style="list-style-type: none"> <li>• registration fee 1% inscription fee of the amount of the mortgage</li> <li>• inscription fee 0.30% of the amount of the mortgage</li> </ul>	Pledge over business/floating charge: 0.5% on the amount of the floating charge
Bulgaria	<ul style="list-style-type: none"> <li>• notary fee: maximum EUR 3,000</li> <li>• land registry fee: 0.01% of the value of the secured amount</li> </ul>	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	<ul style="list-style-type: none"> <li>• real estate security tax: 0.05% of the secured amount</li> <li>• land registration tax: 0.715% of the registered amount</li> </ul>	Up to EUR 150
Hungary	<ul style="list-style-type: none"> <li>• 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</li> <li>• land registry fee: EUR 40 per real estate</li> </ul>	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	<ul style="list-style-type: none"> <li>• land book fee: 0.1% of the value of the obligation but capped at EUR 1425</li> <li>• notary fee: 71 EUR</li> </ul>	Less than EUR 50
Lithuania	• less than EUR 200	n.a.
Luxembourg	<ul style="list-style-type: none"> <li>• registration fee 0.24% of the value of the secured debt</li> <li>• mortgage tax of 0.05% for the first registration and every renewal</li> <li>• notary fee also applies and depends on the value of the secured amount</li> </ul>	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	<ul style="list-style-type: none"> <li>• notary fee: 0.07% of the value of the secured amount</li> <li>• land registry fee: 0.1% of the value of the secured amount</li> </ul>	Up to EUR 100
Slovenia	• less than EUR 150	Up to EUR 100
Spain	<ul style="list-style-type: none"> <li>• notary fee: percentage of the secured amount; fee agreed between the parties and the notary for secured amounts higher than EUR 6 million</li> <li>• registry fee: 0.02% of the secured liability</li> <li>• stamp duty: 0.5% to 1.5% of the secured liability</li> </ul>	n.a.
The Netherlands	<ul style="list-style-type: none"> <li>• less than EUR 150</li> <li>• notary fee: 0.01% of the value of the mortgage</li> </ul>	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 than 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<sup>122</sup>. 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<sup>123</sup> 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<sup>124</sup>: *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

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<sup>123</sup> Or appropriate the asset, depending on the type of the security right.

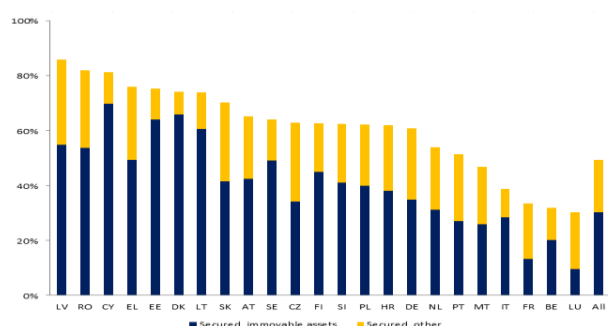
<sup>124</sup> Based on the review of this literature in Berger et al. (2011).

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<sup>125</sup> 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’.

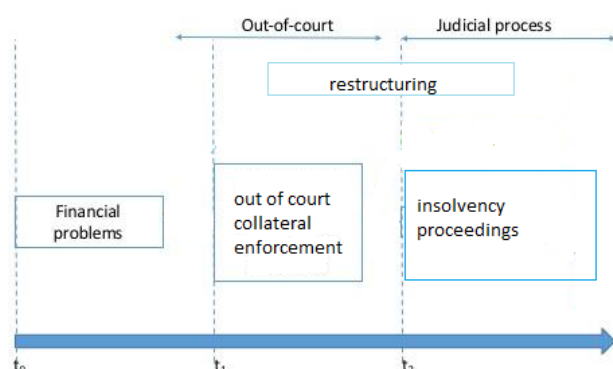
Growing recognition of the burden involved with the official insolvency proceedings, in terms of time and cost for recovering value, has led to much more focus on improving tools available before the company becomes insolvent. Preventive restructuring (also known as pre-

<sup>125</sup> 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)<sup>126</sup>, 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.

<sup>126</sup> <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*"<sup>127</sup>. 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

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<sup>127</sup> 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](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<sup>128</sup>.

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<sup>128</sup> <http://voxeu.org/article/search-european-solution-non-performing-loans>

The NPL ratio<sup>129</sup> 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):

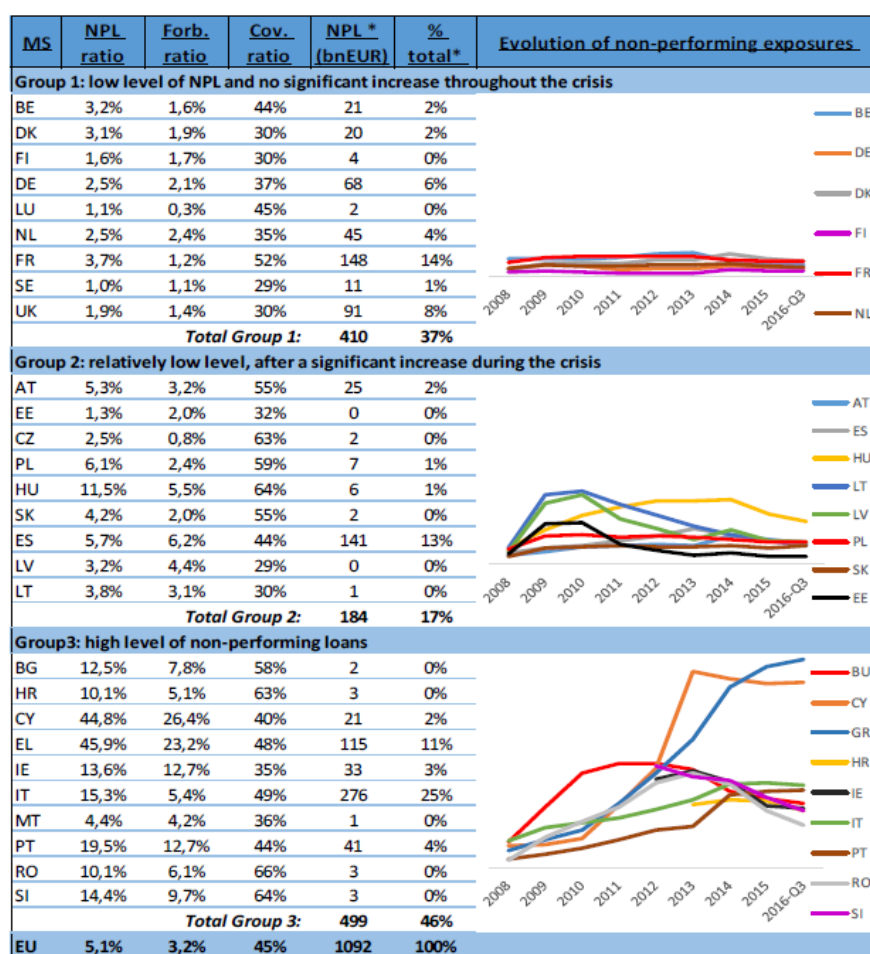
- 9 Member States with low levels of NPLs, and with no significant rise in NPLs during the crisis (group/category 1: Belgium, Germany, Denmark, Finland, France, Luxembourg, the Netherlands, Sweden, UK);
- 9 Member States with low levels of NPLs but which have reported a high level or a high increase 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)

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<sup>129</sup> Average of NPLs/ total loans weighted by total loans



Table 19 – NPL ratios in Member States as of December 2016



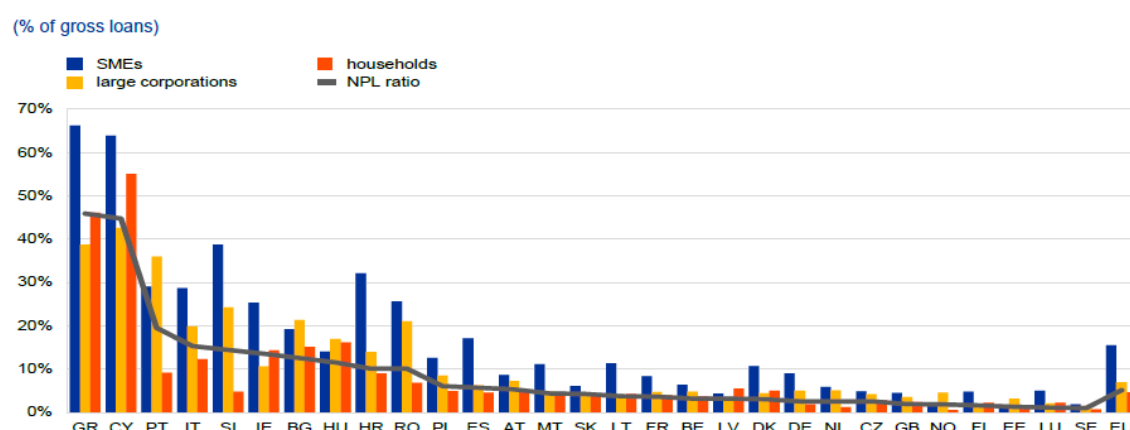
Source: EBA, ECB (\* refers to data available as of June 2016)

More than half of currently impaired loans were extended to non-financial companies<sup>130</sup>. 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<sup>131</sup>. Probability of default rate is also higher for SMEs than for larger companies.

<sup>130</sup> 61% as of Dec 2015 – ESRB Secretariat Based on Consolidate banking data - ECB

<sup>131</sup> FSC Report

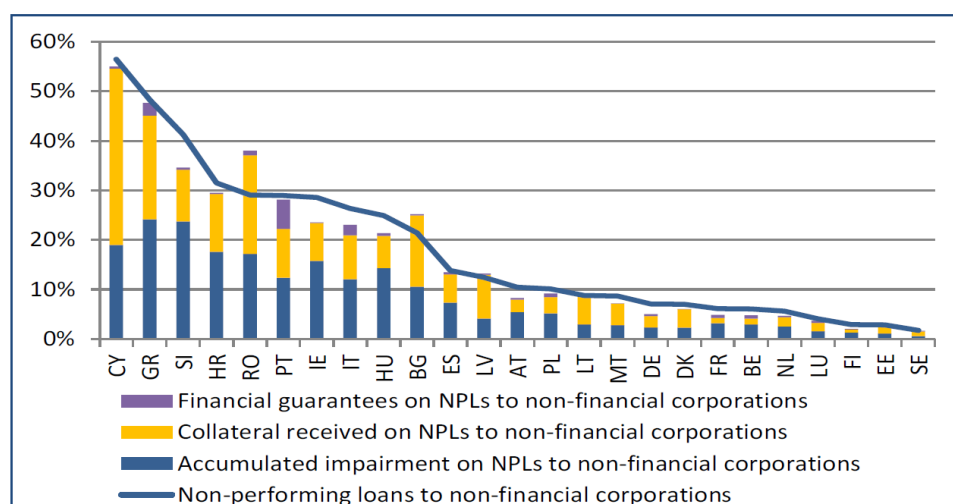
Figure 17 – Non-performing loan ratios by borrower category



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<sup>132</sup>

Cross-border banking brings important stability and risk-sharing benefits, through its effects

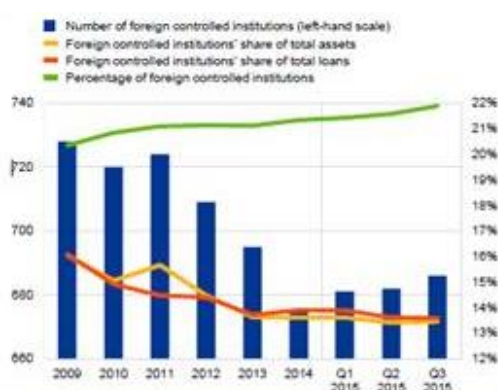
<sup>132</sup> Box based on ECB (2017): "Cross-border banking in the euro area since the crisis: what is driving the great retrenchment?", Financial Stability Review, November 2017.

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<sup>133</sup> 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

<sup>133</sup> Report of the FSC Subgroup on Non-Performing Loans, EF 113 ECOFIN 481, May 2017.

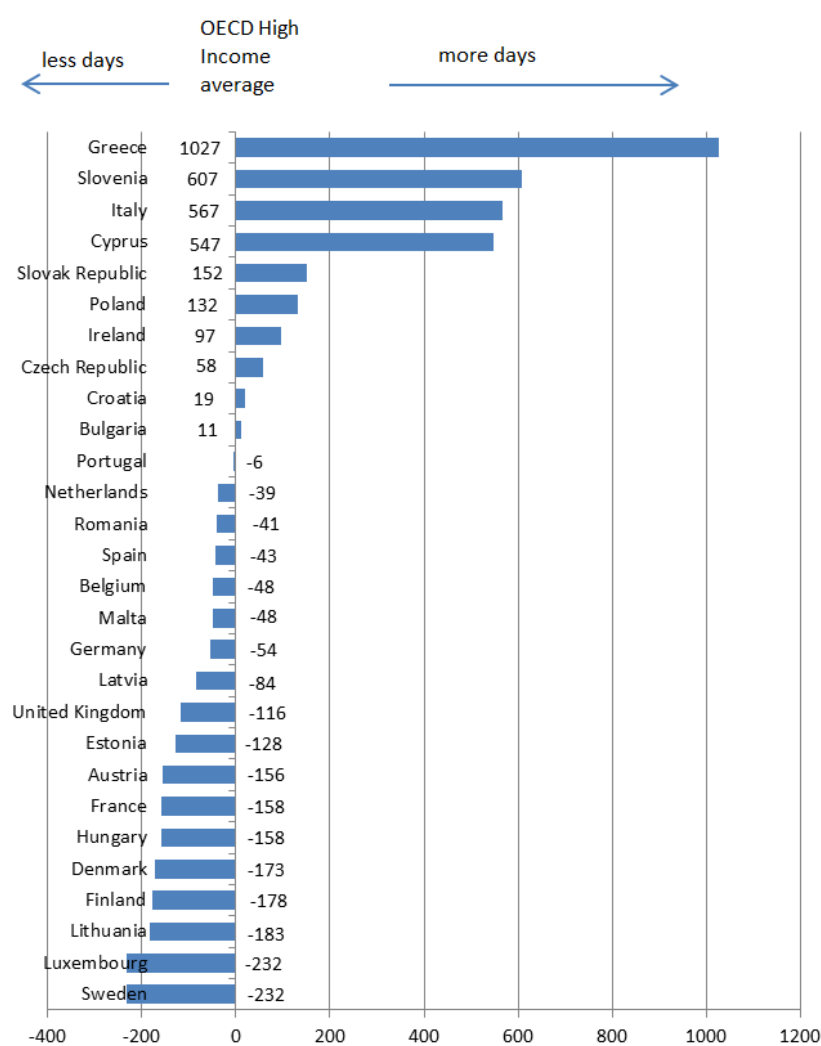
included (latest data current as of June 1, 2016) is the ability to enforce contracts which is related to the efficiency of the judicial system (and ultimately reduces the risk of insolvency and related litigations). The graph below shows how the EU as a region fare compared to other extra-EU regions 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<sup>134</sup>) it can be 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.

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<sup>134</sup> 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 through the courts



Source: Doing business 2017

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