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European Mortgage Federation
European Covered Bond Council (EMF-ECBC)
Position Paper
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EMF-ECBC Response to European Commission's Consultation on the development of secondary markets for non-performing loans and distressed assets and protection of secured creditors from debtors' default

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1. Introduction

The European Mortgage Federation-European Covered Bond Council (EMF-ECBC)[1] welcomes the opportunity to comment on the European Commission's Consultation on the development of secondary markets for non-performing loans and distressed assets and protection of secured creditors from debtors' default which was launched on 10 July 2017.

2. Specific Comments

SECTION II: POTENTIAL MECHANISM TO BETTER PROTECT SECURED CREDITORS FROM DEBTOR DEFAULT

Question 32: Do you see benefits in ensuring that every Member State makes available an instrument along the lines of the 'accelerated loan security' facility?

The benefits in creating such a form of collateral or security primarily would depend primarily on it being carved out from insolvency or pre-insolvency processes. If such an instrument were not carved out, insolvency could be triggered in a swifter manner at the request of the debtor or third parties, in which case the "accelerated loan security" would become a common type of collateral without additional practical use.

Question 33: Do you see the accelerated loan security as a valuable instrument to avoid future accumulation of NPLs in banks' balance sheets?

This measure alone may not facilitate the recovery of non-performing loans. In this respect, it is necessary to reduce the time needed for the recovery of credits in dispute and streamline procedures.

Question 34: Do you agree with the possible main features of an accelerated loan security as described above? If not, what are the features that you do not agree with and why?

According to the consultation document, the bank would have the right to retain or acquire ownership of the encumbered assets with a view to satisfying the secured claims through a sale or by simply taking ownership of the asset. This could mean that banks would have to consolidate newly acquired assets on their balance sheets to the detriment of e.g. capital

[1] Established in 1967, the EMF is the voice of the European mortgage industry, representing the interests of mortgage lenders and covered bond issuers at European level. The EMF provides data and information on European mortgage markets, which were worth over 7.0 trillion EUR at the end of 2015. As of October 2016, the EMF has 19 members across 14 EU Member States as well as a number of observer members. In 2004 the EMF founded the ECBC, a platform bringing together covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. As of October 2016, the ECBC has over 100 members across 26 active covered bond jurisdictions and many different market segments. ECBC members represent over 95% of covered bonds outstanding, which were worth nearly 2.5 trillion EUR at the end of 2015. The EMF-ECBC is registered in the EU Transparency Register under the ID Number 24967486965-09.

allocation requirements. An alternative option which could make more sense would be that the ownership of the encumbered asset is not transferred, but rather that the asset is sold either through a private sale or an auction with proceeds going directly to the lender. In this way, the lender would be satisfied while keeping the assets off the balance sheet.

Indeed, in the case of real estate property, the transfer of ownership to the bank as guarantor might be helpful for a quick recovery, as the bank itself can organise the recovery process, however, the transfer of property itself raises a number of concerns which would have to be addressed in order for an "accelerated loan security" to be relevant:

- In the case of properties run by operating companies, the ownership would change with the transfer of the property, however the related contracts and authorisations (management contracts, employment contracts etc.) are not automatically transferred with the property.
- The transfer of the property could involve unforeseeable risks for banks. For example, liability for tax and other liabilities of the previous owner, responsibility for employment contracts, removal of contaminated sites.
- The transfer to real estate involves charges and taxes. The transfer of property by means of ALS would involve higher costs than the transfer by means of a judicial foreclosure procedure.
- The position of second ranked creditors is normally determined in the judicial foreclosure procedure. It often expires if no proceeds are left in the foreclosure procedure. In the event of a resale of the property the bank would be obliged to find a solution for second ranked creditors.
- In the case of syndicate financing, joint legal positions are usually excluded. In the event of recovery of real estate by means of transfer of the property there would be joint property of syndicate members. This would raise many legal questions, as well as issues around the management of the property etc.

Another concern is that debtors should not be fully discharged from further repayment obligations when the recovered value from the sale of assets is lower than the value of the outstanding loan; in fact, recourse to this mechanism should be possible only if the value from the sale of assets is larger than the debt. Such discharge could encourage moral hazard and induce debtors to act irresponsibly and increase speculative behaviour, especially when asset values decrease. Full discharge of debtors would introduce a dangerous derogation to the principle that debts are to be fully paid. Furthermore, full debt discharge may be counterproductive since it does not promote a responsible entrepreneurship model.

A final consideration here is that the creation of such a security by debtors should not be more expensive or more cumbersome in terms of publicity and registry cost than other securities /collaterals while the sale thereof, after transfer of ownership in the event of default, should be conducted in a commercial manner (with prior valuation, with proper publicity in advance etc.) to derive the best value. Any related tax impacts of such an operation would need to be addressed as well (e.g., VAT treatment).

Question 35: What are the (additional) features that an accelerated loan security should have in order to enhance its effectiveness in avoiding the encumbrance of bank balance sheets with further NPLs in terms of functioning of the mechanisms?

Following on from the responses to questions 34 above, if real estate property were deemed to be a target, consideration should be given to the following:

- Banks should have the possibility to raise objections to the estimate of the property carried out by the expert appraiser;
- It should be possible to transfer the not only to creditors but also to third parties appointed by creditors;
- Banks should have the possibility to disregard the accelerated loan security clause even if this clause was agreed with the borrower in the credit contract and to decide to activate the traditional enforcement procedures;
- If certain conditions exist, banks and debtors should have the possibility to way out of the activated accelerated clause and for the banks to activate traditional enforcement procedures;
- Security could be registered in a public register. This would be a legally certain and cost-efficient method of a creation of a security. The efficiency of this type of security could be further enhanced if there was priority over other securities;

- In addition, lenders should be allowed (and granted free of charge) access to all public and private data registers (Chambers of Commerce, cadastral offices, mortgage registries, credit registries, real estate transactions, length of foreclosures from PST Justice database, etc.), so that banks can perform proper due diligence before deciding to activate "private" foreclosure process.

Moreover, it could be appropriate to specify that the accelerated loan security includes movable assets registered in public offices (such as ships and aircrafts).

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

As a matter of principle, there should be no restrictions on the ability of lenders to enforce claims against residential property - whether it be the primary residence or not - or against borrowers. In fact, the ability of the lender to enforce the collateral as a last resort is a cornerstone of the mortgage lending business - as well as a requirement in the Capital Requirements Regulation (CRR) - which makes mortgage credit a low cost and low risk way of providing mortgage finance.

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

A discharge of debts in the event that the value of the assets were to fall below the level of the debt cannot be supported. Overall, the credit security allows the lender to enforce his claim against the debtor for repayment of the loan, also in a situation where the debtor is not willing or able to do so. If a discharge of debts were possible in the event that the value of the assets were to fall below the level of the debt, the security would no longer guarantee the lender's claim against the debtor for repayment of the loan. The lender's position would be worse than without security and its risk would increase.

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

According to the consultation document, national rules and principles of pre-insolvency and insolvency proceedings would prevail over the accelerated loan security, meaning that the contractual security right for the bank would only be enforceable as long as the debtor is not in financial distress. This aspect would significantly weaken the value of the security and would discourage banks holding such security from supporting restructuring efforts for a debtor's potentially viable business, for example. Furthermore, it would likely limit the viability, effectiveness and relevance of the accelerated loan security severely, since such collateral is generally most relevant in times of financial distress for the debtor. In essence, if an accelerated loan security were not carved out from pre-insolvency and insolvency proceedings, it would be a normal collateral and ultimately would not serve the purposes of its creation.

For the full effect of the collateral to be realised, the accelerated loan security would have to be enforceable even when a debtor enters into an insolvency or preventive restructuring proceeding. Avoidance actions should still apply to this type of collateral in order to safeguard the rights of other creditors.

Alignment with restructuring frameworks and insolvency law should be ensured via the types of assets that may be taken as "accelerated loan security" (e.g., receivables, inventory etc) and in terms of the manner in which such assets should be sold by banks in case the debtor is in insolvency / pre-insolvency (e.g., one option would be for the sale to be carried out by banks under the supervision of the insolvency practitioner in a manner consistent with insolvency practices).

Question 39: How should an accelerated loan security instrument be designed in order to be consistent with the public and private law rules and principles (including for instance property law, public and private law) of your country? In your view, what would be the main obstacles to ensure such consistency?

The accelerated loan security as described is a contractual right and would have to be tailored by each Member State in order to accommodate existing legal frameworks of private law, which are highly diversified within the EU.

Based on the feedback received, one of the main obstacles are the current privileges granted to the debtor as the weakest party, which tend to weaken negotiations for its future possibility of opposition or revocation. Bankruptcy laws and excessive discretion of the judiciary could undermine the instrument. The ranking of privileges needs to be clarified by law since it is not entirely clear nor definitive, and many times it has been defined by court decisions and not by law.

Question 40: How should an accelerated loan security instrument be designed in order to be consistent with the existing national collateral legal framework?

The accelerated loan security would have to provide for specific rules in terms of its relationship with the other collaterals provided by the law of different countries (e.g. mortgages, pledges).

The accelerated loan security should supplement the existing options for collateral that debtors currently have at their disposal. The option to use this new security right for banks should be used only when agreed upon by the contracting parties (lender and debtor) and should not impose restrictions on the use of other forms of collateral that are currently available in Member States.