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European Commission Proposals to Tackle Non-Performing Loans

Background

Last month, the European Commission (the "**Commission**") presented its Second Progress Report on the Action Plan to address non-performing loans ("**NPLs**") in Europe (the "**Second Progress Report**").

The Second Progress Report proposes a "comprehensive package" of measures designed to tackle the issues in this area. The Commission has indicated that it considers the resolution of existing NPLs and the prevention of the excessive build-up of NPLs in the future as essential to complete the EU Banking Union.

The Second Progress Report outlines the progress that has been made to date in this area, noting that there has, and continues to be, a steady reduction in NPLs across nearly all Member States, while acknowledging that the situation across Member States differs significantly[1]. Nonetheless, even in those Member States that still have high NPL ratios, there has been progress, due to a combination of policy actions and economic growth.

[1] At the end of Q3 2017, several Member States had low NPL ratios (10 Member States had ratios below 3%). Others had high ratios (8 Member States had ratios above 10%).

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EU Legislative Proposals

The Commission's package of measures contains two legislative proposals (the "**Proposals**"), being: (i) a proposal for a Directive on Credit Servicers, Credit Purchasers and the Recovery of Collateral (the "**Proposal for Directive**"); and (ii) a proposal for a Regulation amending the Capital Requirements Regulation[2] (the "**Proposal for Regulation**").

This Proposals contain four key areas:

1. Bank Supervision and Regulation - ensuring banks retain funds to cover risks involved with loans issued in the future that may become non-performing

The Commission proposes certain statutory prudential backstops, which would amount to the minimum levels of provisions that banks would be required to retain in order to cover losses on loans that later become NPLs. The Proposal for Regulation introduces a common definition of "non-performing exposures" which is in line with that used for supervisory reporting purposes. It is anticipated that this will ensure that financial institutions will have sufficient loss coverage for any such exposures. If a bank fails to comply with the applicable minimum level, deductions may be made from its own funds.

2. Development of a regulated and harmonised secondary market where banks can sell NPLs

Member States currently have different rules in relation to how non-credit institutions may purchase credit agreements from credit institutions; this leads to an inefficient market for NPLs. The Proposal for Directive seeks to harmonise the rules for secondary markets across all EU Member States and to make NPLs more accessible to credit servicing by third parties by lowering the cost of entry for loan purchasers and reducing the costs of credit servicing.

At present, credit servicing by a body other than an EU credit institution is unregulated at an EU level. This proposal would require credit servicers to obtain prior authorisation from a designated authority within each Member State. It would also require each Member State to put forward a national authority to supervise credit servicers (to the extent that there is not already one in being in

[2] Regulation (EU) No 575/2013.

that Member State). This may require certain amendments / modifications to Ireland's credit servicing regime in due course. For recent domestic developments in this area please see our note: "Loan Sales in Ireland – Proposed Regulatory Changes".

3. Reforms of national restructuring, insolvency and debt recovery frameworks - facilitating debt recovery by way of an accelerated extrajudicial collateral enforcement procedure ("AECE")

The Commission's proposal here would allow lenders to realise collateral for loans more efficiently. The Proposal for Directive makes available to banks more effective methods to recover their money from secured loans out of court. This procedure would be available if agreed upon in advance by the lender and the borrower. It is not proposed that AECE would apply to consumer loans. AECE aims to reduce the costs involved in dealing with NPLs and to support both credit institutions and purchasers of NPLs.

4. Assisting Member States in the restructuring of banks

The Commission's legislative package also includes a working document on a blueprint for providing non-binding technical guidance as to how national asset management companies ("**AMCs**") can be established by Member States. AMCs are considered to be an "exceptional solution" for NPL issues in Member States. The blueprint, which is based on an analysis of the operation of pre-existing AMCs in EU Member States, outlines a number of key principles on the establishment, governance and running of AMCs.

Conclusion

Since the financial crisis, NPLs have presented one of the most significant risks to the European banking system. The Proposals, which form part of the EU's overall strategy to reduce risk within the financial services sector, aim to build on the progress made to date in relation to NPLs and to formulate a plan to prevent the accumulation of new NPLs in the future. The Proposals represent a significant step forward in the development of the EU's Banking Union, which has as one of its key aims the establishment of a more effective pan-European platform for banks to address the issue of NPLs.

The Proposals are now subject to review by the EU Parliament and Council. We will continue to update you in relation to future developments in this area as they arise.

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