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EU LEGISLATIVE MEASURES FOR NON-PERFORMING LOANS – IMPACT ON THE LOAN MARKETS: NEW REGULATION OF LOAN TRANSFERS, NON-BANK LENDERS AND FACILITY AGENTS

A recently released EU legislative package[1] aims to facilitate the reduction of non-performing loans ("**NPLs**") held by European banks now and in the future. However, it contains unexpected measures which are not confined to NPLs and which will bring significant change to practice in the existing secondary loan market and also the primary loan market. These include compulsory levels of disclosure and reporting requirements on loan transfers to non-banks; a requirement for pre-enforcement notification by non-bank lenders; and potential regulation of facility agents and credit fund managers as "loan servicers". Although the package is going through the EU legislative process there is an opportunity for market participants to submit feedback which will inform the legislative debate. The window for feedback is currently scheduled to close on 8 June 2018.

The context

A loan is classified by the EU as an NPL if payment is more than 90 days overdue or it is assessed to be unlikely to be repaid by the borrower. Reduction in the number of NPLs held by European Banks has been identified by the EU as a key priority. This is because high stocks of NPLs weigh on bank performance and reduce capacity to lend, including to SMEs which are particularly affected by credit supply. This affects economic growth and job creation. To this end the EU Commission has conducted consultations on the development of secondary markets for NPLs, the protection of secured creditors from borrowers' default and the introduction of provisions to cover incurred and expected losses on newly originated loans.

Key points

- New EU legislation might cause significant disruption to existing practice in the secondary and primary loan markets.
- Measures include:
  - compulsory levels of disclosure on loan transfers to non-banks
  - reporting of loan transfers to non-banks
  - requirements for non-banks which purchase a loan to have a representative in the EU and to notify authorities prior to enforcement of that loan
  - potential regulation of facility and security agents which are not EU established banks and of credit fund managers
  - potential restriction on any non-EU entity acting as a facility agent, security agent or credit fund manager in respect of a loan originally made by an EU established bank.
- The measures have wide extra-territorial effect and will apply to non-EU entities.
- The measures are going through the legislative process.
- The opportunity to provide feedback is currently scheduled to close on 8 June 2018.

[1] Proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral and Proposal for a Regulation of the European Parliament and of the Council on amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures

Following those consultations, the Commission has now adopted legislative measures designed to assist in the creation of an appropriate environment for banks to deal with existing and future NPLs.

The legislative package and scope of this briefing

The legislative package consists of an EU Regulation and an EU Directive and is wide-ranging. This briefing does not cover it in full and in particular does not address either:

- the Regulation which amends the Capital Requirements Regulation to provide for minimum loan loss coverage requirements in respect of NPLs. (This is intended to create incentives for banks to address NPLs at an early stage and to avoid too great an accumulation of NPLs); or
- that part of the Directive which seeks to establish an out-of-court security enforcement mechanic in each member state. (This is intended to provide a more efficient enforcement mechanism for secured loans to allow banks to address NPLs.)

This briefing concentrates on those measures in the Directive which aim to encourage the development of secondary markets for NPLs by:

- creating a pan-EU regulatory framework and common standards for "loan servicers" (this is intended to allow for greater cross-border competition among loan servicers across the EU and increase the accessibility, and reduce the costs, of loan servicing for potential buyers of loans); and
- removing impediments to loan transfers to non-bank institutions, such as requiring member states to lift any existing restrictions in national law (such as licensing requirements) which prevent loan transfers being made to non-banks.

It is important to note that the legislative intention is laudable and that there appear to be a number of positive elements. Particularly notable is the acknowledgement that market participants to which drawn loans are transferred ought not to attract licensing requirements by virtue of such activity. The corresponding requirement for member states to lift any existing restrictions in national law which prevent loan transfers being made to non-banks is welcome news for both the primary and secondary loan markets.

However, a number of the measures in the Directive risk undermining this intention by causing significant disruption to practice in the existing primary and secondary loan markets. This briefing focuses on giving an initial overview of what, at first glance, appear to be the most pressing concerns from this perspective:

- new requirements for loan transfers to non-banks;
- new requirements for non-bank lenders; and
- new regime for "*credit servicers*" and potential impact on facility and security agency functions and credit funds.

New requirements for loan transfers to non-banks

Introduction and applicability

Non-banks (such as funds, other CLOs and institutional investors) constitute a significant proportion of lenders on primary syndication and buyers in the existing secondary loan market. The Directive sets out a number of requirements to the making of loan transfers to non-banks.

It is important to note that the requirements will apply to **all** loan transfers made to non-banks and apply to transfers of performing loans as well as NPLs. This is explained as a deliberate policy choice driven by a desire to avoid market fragmentation and additional costs on the sale of mixed portfolios. The result is to give the new requirements for loan transfers to non-banks a much wider application than might have been expected.

It is unclear whether the requirements are intended to apply only to a transfer of a lender's rights and obligations or whether they are intended to also apply in the case of a bare assignment of a lender's rights or the use of a synthetic arrangement such as a sub-participation.

The requirements have wide extra-territorial effect. They apply to each transfer to a non-bank of a loan that was originally made by an EU established bank. (See box: *Loan originally made by an EU established bank*). On the face of it this would mean that, for example, the transfer from a US credit fund to a Chinese credit fund of a participation in a New York law facility agreement originally entered into by a bank incorporated in the EU would be within the scope of the requirements.

The new requirements are outlined below:

Mandatory disclosure

Both the existing secondary loan market and the primary loan market operate on the basis of the "*buyer beware*" principle. There is no English law requirement for an existing Lender to make available any information or disclosure in relation to the relevant loan. Indeed, in many cases participants in the secondary loan market operate on the basis of provisions (sometimes termed "*big boy*" clauses) which expressly acknowledge a potential asymmetry of information between the existing Lender and new Lender. Of course, the commercial agreement may be that a certain level of disclosure is made to the new Lender and contractually warranted by an existing Lender – but that is a matter of commercial agreement rather than mandatory requirement.

The Directive envisages that an existing Lender will be required to provide a non-bank new Lender with "*all necessary information*" to enable that new Lender to assess the "*value of the credit agreement*" and "*the likelihood of recovery of the value of that agreement*". If the existing Lender is a bank there is an additional requirement that the information provided to the new Lender be set out in a data template to be developed by the European Banking Authority. That template is intended to "*provide detailed information on…credit exposures in the banking book to [new Lenders] for the screening, financial due diligence and valuation of the credit agreement*".

This obligation seems intended to address the consultation's findings that banking secrecy issues lead to a lack of high quality information being made available to potential new Lenders which are non-banks and that the resulting information asymmetry is the main obstacle to the development of secondary markets in NPLs. The consultation found that the lack of uniformity of data was also an obstacle. In that context measures which facilitate disclosure to non-banks are understandable and consistent with the aim of developing secondary markets in NPLs.

However, this disclosure obligation is not limited to NPLs and applies to all transfers to non-banks of performing loans as well as of NPLs. On the face of the Directive's current wording it would appear that the obligation will apply to all loan transfers to non-banks made as part of primary syndication or

Loan originally made by an EU established bank

A number of the measures in the Directive discussed in this briefing relate to loans originally made by an EU established bank. There are two particular areas of uncertainty connected to this concept:

- The position regarding loans made by UK established banks is hard to establish definitively because of the uncertainties inherent in the UK's withdrawal from the EU. If the recently announced transition period comes into effect the UK will be treated as if it were an EU member state until the end of 2020. On its face that suggests that the measures will apply to loans made by a UK established bank. The position is likely to be complicated however by the fact that national implementing legislation is required to become effective only in 2021 – after the expiry of that transitional period.
- The Directive is not written from the perspective of a syndicated lending arrangement and so it is unclear whether the presence of a single EU (or UK – see above) established bank in the original lending syndicate would bring the whole facility agreement within scope or whether the requirements would apply only to that single bank's participation.

secondary trading. Additionally, the requirement goes further than the mere facilitation of any commercially agreed disclosure. Instead it mandates a minimum disclosure standard to all loan transfers to non-banks irrespective of the commercial agreement between existing Lender and new Lender on disclosure. This contrasts starkly with well-established existing practices and introduces a significant practical hurdle. The scope of the duty also raises a number of difficult issues, for example:

- it is not clear if the duty is intended to be limited to information actually held / known by the existing Lender or, if so, whether this to be assessed on a subjective or objective basis;
- there could be significant compliance difficulties in large organisations where information is held in different places or behind information barriers;
- there will be understandable concerns about liability for information provided. It is unlikely that liability could be successfully excluded in respect of information provided pursuant to a statutory requirement; and
- many non-banks active in the existing primary and secondary loan markets lack the infrastructure to establish information barriers and so operate on the basis of limited "public" information only. This enables them to avoid receiving information that would prevent them from trading in related securities. When receiving a loan transfer such institutions typically request not to receive non-public information from an existing Lender about the relevant loan. It is not clear how such an arrangement would square with this disclosure obligation.

The introduction of such a minimum disclosure standard could risk being a sufficient change to market practice in both the existing secondary market and at primary syndication such as to act a significant disincentive for existing Lenders to make loan transfers to non-banks at either stage.

Reporting

On completion of any loan transfer to a non-bank an existing Lender will be required to notify the relevant national authorities of the completion of that loan transfer and of the identity and address of the new Lender.

This reporting requirement seems to be driven primarily by concerns that there are no official statistics which can be used to track the volume of activity in the secondary markets for NPLs.

However, the reporting obligation is not limited to secondary transfers of NPLs and applies to all transfers to non-banks of performing loans as well as NPLs. On the face of the Directive's current wording it would appear that the obligation will apply to all loan transfers to non-banks made as part of primary syndication or secondary trading. The introduction of such a requirement would clearly impose a significant administrative and compliance burden on all institutions involved in either primary syndication or secondary trading of loan assets.

New requirements for non-bank lenders

Introduction and applicability

The introduction of new requirements for non-bank lenders may seem counter-intuitive in the context of the lifting of national laws which might otherwise restrict loan transfers to non-banks. However these new requirements are best understood as accompanying, and being intended to

address potential drawbacks perceived to be associated with, that liberalisation.

As in relation to transfers to non-banks described above, these requirements are triggered by a transfer to a non-bank of a loan (whether in primary syndication or as part of a secondary trade) that was originally made by an EU established bank. (See box: *Loan originally made by an EU established bank*.) It is equally unclear whether they are intended to be triggered only in the instances of full transfers or whether they are intended to also be triggered by a bare assignment of a lender's rights or the use of a synthetic arrangement. They would have a similarly wide extra-territorial application to non-banks which are not established in the EU.

The new requirements are outlined below:

Pre-enforcement notification

A non-bank to which a loan transfer is made (whether of a performing loan or an NPL and whether in primary syndication or as part of a secondary trade) will be required to inform the relevant national authority of its intention to enforce the facility agreement before doing so. It will also be required to provide details of the type of asset securing the facility, whether it is made with a consumer, the value of the facility, the identity and address of the borrower and its own identity and address.

The requirement appears to be driven by a desire to ensure that borrowers are not disadvantaged by the transfer of a loan to a non-bank and to ensure that non-banks carry out enforcement in compliance with applicable borrower protections. Whilst perhaps understandable in a consumer or SME context the practical effect of the proposal in a syndicated lending transaction is likely to be to hamper a lending syndicate's ability to enforce quickly when the circumstances demand.

Representative in the EU

A non-bank to which a loan transfer is made (whether of a performing loan or an NPL and whether in primary syndication or as part of a secondary trade) and which is not domiciled or established in the EU will be required to appoint an EU domiciled or established representative. That representative will be responsible for that non-bank's obligations under the Directive.

The position regarding non-banks domiciled or established in the UK is hard to establish definitively because of the uncertainties inherent in the UK's withdrawal from the EU. If the recently announced transition period comes into effect the UK will be treated as if it were an EU member state until the end of 2020. On its face that suggests that such non-banks will be treated as being established in the EU for the purposes of the Directive and so exempt from this requirement. The position is likely to be complicated however by the fact that national implementing legislation is required to take effect only in 2021 – after the expiry of that transitional period.

The requirement appears to be driven by concerns that the liberalisation of national laws which might otherwise restrict loan transfers to non-banks may make it harder for consumers to rely on their rights under EU law and for national authorities to supervise enforcement of the facility agreement. These concerns are understandable in that context, however, the requirement is not confined to transfers of consumer loans and, as drawn, seems to apply to all loan transfers. Such a requirement might make more sense when viewed

through the prism of the potential extra-territorial application of the Directive's measures to non-banks which are not established in the EU.

Non-EU entities already participate in the existing secondary loan market and also in primary syndication. This new requirement has the potential to make their continued participation much more difficult. Chief amongst the difficulties will be the challenge of persuading a third party to act as their representative and to be responsible for their obligations under the Directive. Depending on the jurisdictions involved it could also create tax uncertainty.

Notification of use of credit servicing

A non-bank to which a loan transfer is made (whether of a performing loan or of an NPL and whether in primary syndication or as part of a secondary trade) will be required to notify the relevant national authorities of the identity and address of any institution that they appoint to carry out credit servicing activities.

For the reasons outlined below, this is likely to mean that non-banks will be required to notify the authorities of the name and address of the facility agent and security agent under a syndicated facility agreement, and credit funds may be required to notify the authorities of the name and address of any entities in their structure carrying on such a role.

New regime for "*credit servicers*" and potential impact on facility and security agency functions and credit funds

Introduction and applicability

The Directive sets out a regulatory framework for entities which are classed as "*credit servicers*". Such entities are required to be authorised in their member state and are to be subject to a number of requirements. Those requirements include prescribed documentation standards, restrictions on outsourcing and a requirement to be incorporated in the EU. Banks are exempt from the "*credit servicer*" framework but it is unclear whether this exemption is intended to exempt all banks or only those established in the EU.

The position regarding institutions incorporated or established in the UK is hard to establish definitively because of the uncertainties inherent in the UK's withdrawal from the EU. If the recently announced transition period comes into effect the UK will be treated as if it were an EU member state until the end of 2020. On its face that suggests that UK incorporated or established institutions will be treated as being incorporated or established in the EU for the purposes of the Directive. UK incorporated non-banks would therefore be capable of being regulated as "*credit servi*cers" and UK established banks would be exempt from the regime. The position is likely to be complicated however by the fact that national implementing legislation is required to take effect only in 2021 – after the expiry of that transitional period.

Whilst it appears that these measures are aimed at institutions (often referred to as "loan servicers" or "debt administrators") which actively manage loans (particularly consumer and SME loans) and take decisions for investors who lack the capability, infrastructure or desire to do so, the definition of "*credit servicer*" is very wide. It includes any entity which, on behalf of a lender: "*monitors the performance of the credit agreement*", "*informs the borrower of any changes in interest rates…under the credit agreement*" or "*enforces the rights and obligations under the credit agreement on behalf of the creditor, including administering repayments*".

As with the measures described above the regime applies to any "*credit servicer*" of a loan (whether a performing loan or an NPL) that was originally made by an EU established bank. (See box: *Loan originally made by an EU established bank.*)

Facility agents and credit funds

The definition of "*credit servicer*" seems likely to include a facility agency or security agency role under a syndicated loan agreement, notwithstanding that under syndicated lending arrangements the facility agent and security agent are appointed for reasons of administrative convenience, act on the instructions of the lenders and have a purely mechanical and administrative role with limited discretion.

As above, facility agents and security agents which are banks (or possibly only banks established in the EU) will be exempt from the "*credit servicer*" regime. However a recent trend in the loan markets has been the use of specialist non-bank service providers in the facility agent and security agent role. These entities would fall within the regime and become subject to regulatory requirements which seem out of place in that context. Any such non-bank agent which is not incorporated in the EU (see above for the position regarding UK incorporated entities) will be in a very difficult position. They will be required to be authorised but will be unable to obtain the appropriate authorisation by virtue of not being incorporated in the EU. The effect will be to prevent them from acting as facility agents or security agents in respect of loans originally made by an EU established bank (see box: *Loan originally made by an EU established bank*).

If only EU established banks are exempted from the credit servicer regime then facility agents and security agents which are banks not established in the EU will experience similar difficulties. (See above for the position regarding UK established banks.)

The definition also seems likely to include entities within fund structures (such as a fund manager or investment adviser) which manage loan participations on behalf of their credit funds. Those entities would also become subject to regulatory requirements which would seem equally out of place. Similar issues to those described above would apply to structures outside of the EU. (See above for the position regarding UK structures.) This collectively could be a significant disincentive for credit funds to purchase loans originally made by EU established banks (see box: *Loan originally made by an EU established bank*).

It would appear from the impact statement which accompanies the Directive that neither facility agents, security agents nor fund managers are the primary focus of the "*credit servicer*" regime. However, the consequences of their (possibly inadvertent) inclusion are significant.

Next steps

The Directive has been adopted by the Commission and put forward for adoption by the EU Parliament and Council. The Commission has invited interested parties to submit feedback to the Commission on the Directive and accompanying impact assessment by (currently) 8 June 2018. A summary of all feedback received will be presented to the EU Parliament and Council to inform the legislative debate.

The text of the Directive, impact assessment and feedback information can be found here.

The Directive will require implementation in each member state pursuant to domestic legislation. Once adopted by the EU Parliament and the Council the Directive would be required to be implemented by member states into their national legislation by the end of 2020, with that national legislation required to be applied from January 2021 or, in the case of the "*credit servicer*" regime, July 2021.

UK implementation

The UK's position is hard to establish definitively because of the uncertainties inherent in the UK's withdrawal from the EU. If the recently announced transition period comes into effect EU law will apply in both the UK and the EU as if the UK continued to be a member state until the end of 2020. This would mean that the UK would be in the curious position of being required to *enact* into national legislation the Directive by the end of 2020 but then not required to *apply* that enacting legislation from January 2021.

This is likely to be a matter for the negotiations between the UK and the EU on their future relationship following the UK's withdrawal. However, the practical reality may well be that the extent to which the UK applies the new requirements will be correlated with the extent to which it is agreed that the UK be treated as constituting part of the EU for the purposes of the application of the measures in the EU27.

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