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NPL PORTFOLIO DISPOSALS: A WAY FORWARD?

A number of broader macroeconomic drivers look likely to increase the relevance of the secondary markets for non-performing loans in H2 2023. These include the COVID aftermath, the Ukraine war and rising interest rates. Combined with regulatory pressure to reduce NPL exposures, EU banks are likely to be looking for ways to exit NPL positions. In this article, we examine the options available to EU banks in light of the EU NPL Directive and the disclosure templates the EBA recently published for use in NPL portfolio sales.

This is an update of an article originally published on 5 June 2023 as part of our publication "Securitisation markets and regulation: choosing different paths?", accessible here.

Key Issues

- Implementation of NPL Directive by Member States is not yet finalised and therefore its influence on the NPL market in the European Union remains uncertain.
- In light of EBA's Final Report on the new disclosure templates ("**ITS**"), EU Banks might need to reconsider their standard documentation, confidentiality agreements and internal systems.
- The ITS expand the range of exemptions available to EU Banks.

Consequences of NPLs on Banks' Balance Sheets

Numerous studies have investigated the negative consequences of high levels of non-performing loans ("NPLs") on the balance sheets of financial institutions. They show that, besides the pressure that NPLs are putting on individual banks' profitability, management costs and capital constraints, high NPL stocks can also exacerbate macroprudential fragilities and potentially trigger negative macroeconomic feedback loops through reduced credit supply from banks.[1]

In response to heightened NPL levels observed in a range of euro area countries, banks have made increased use of securitisations in recent years to reduce NPL stocks. As a result, NPL securitisations have quickly become an important tool in efforts to improve the soundness and efficiency of the European banking system by aligning the interest of banks, investors and public authorities. This remains true whether or not state involvement is required to make such securitisation transactions viable in the markets, as has sometimes been the case.

[1] Council of the European Union, Report on the FSC Subgroup on Non-Performing Loans of 31 May 2017, 9854/17; Gattini, Luca / Gereben, Áron / Kolev, Atanas / Csonto, Balazs / Brutscher, Philipp-Bastian, EIB CESEE Bank Lending Survey H1-2014; Garrido, José / Kopp, Emanuel / Weber, Anke, Cleaning-up Bank Balance Sheets: Economic, Legal and Supervisory Measures for Italy, IMF Working Paper No. 16/135.

The NPL Directive and EBA's Final Report on Disclosure Templates

The NPL Directive

An important element of the EU regulatory structure governing the secondary market in NPLs is the EU directive on credit servicers and credit purchasers (Directive (EU) 2021/2167) ("**NPL Directive**"). The NPL Directive was approved in late 2021 but does not need to be implemented until 30 December 2023. With only months left until that deadline, most Member States have not yet implemented, leaving significant uncertainty in the detail of its requirements.

In broad terms, the NPL Directive will regulate the sale, purchase and servicing of portfolios of non-performing loans originated by EU banks. The directive is part of the EU action plan to reduce the current stock of NPLs in the EU and to prevent the build-up of that stock in the future. It aims to encourage growth of the secondary market for NPLs by improving the information available to buyers (such as pre-sale disclosure and post-sale reporting obligations)[2], reducing the regulatory impediments to non-banks buying loans across the EU, and creating a new category of authorised entity that can provide loan servicing support across the EU, all while protecting borrowers and improving supervisory oversight. However, there are signs the NPL Directive could already be affecting the market for both performing and non-performing loans as market participants prepare to comply with the disclosure, reporting, borrower protection, systems and controls, authorisation and other obligations that will apply when the new rules to be implemented by Member States take effect at the end of this year.

The final draft ITS and disclosure templates

In addition to Member States' implementation of the NPL Directive, market participants will also need to be mindful of NPL disclosure templates drafted by the European Banking Authority ("EBA") for use across the EU. A final draft of those templates was published on 16 December 2022 by the EBA as part of its final draft implementing technical standards under the NPL Directive ("ITS"). The EBA will submit this finalised proposal to the European Commission following which the Commission will adopt the ITS (with or without amendments). The objective of the draft ITS is to facilitate comparison of NPL portfolios across EU Member States by standardising the content and format of disclosure and also to reduce information asymmetries between sellers and buyers of NPLs by ensuring a common minimum standard of disclosure. EU banks will have to provide granular loan-by-loan information to enable prospective buyers to conduct their analysis, financial due diligence and valuation of NPLs. There are sell-side concerns about the practicality of providing all this data as well as practical questions on the buy side about whether the information required by the templates will prove useful in practice.

EU banks will have to use the data templates for transfers of NPLs held in their banking book taking place on or after 30 December 2023 where the loans were originated on or after 1 July 2018 and became non-performing after 28 December 2021. However, for NPLs originated between 1 July 2018 and the entry into force of the ITS, EU banks need only complete the date templates with the information already available to them.

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[2] Please also refer to our December 2021 briefing entitled "*Implementing the new EU rules on non-performing loans*": https://www.cliffordchance.com/briefings/2021/11/implementing-the-new-eu-rules-on-non-performing-loans.html

The ITS prescribes the use of five templates to be completed by the selling bank on a loan-by-loan basis and specify 129 data fields to be completed:

- The **counterparty template** requires the bank to provide information identifying the counterparties to the exposure, such as the borrower or any protection provider.
- The **relationship template** requires the bank to specify how each element of an NPL relates to each other element reported on, using unique identifiers. By making clear e.g. which counterparty relates to which loan, which bit of collateral is pledged to secure which loan, or which protection provider is providing each guarantee, prospective purchasers of the portfolio can better understand what they might be buying.
- The **loan template** requires disclosure of information on the loan agreement and the loan such as the cut-off date, asset class to which the loan belongs, loan currency, accrued interest or date of the default status.
- The **collateral, guarantee and enforcement template** requires disclosure of information on the type of collateral provided for the loan, in particular disclosure of specific information on mortgage guarantees.
- The **historical collection and repayment template** requires the bank to provide details of historical collections over the last three years (aggregated by month).

Despite revisions made as a result of industry consultation and designed to improve the proportionality of the templates, many of the proposed requirements still present significant challenges for EU banks, such as the mandatory disclosure of the selling bank's latest internal and external valuations of collateral (even though this will raise concerns about the selling bank's liability and its right to disclose external valuations).

In addition, the draft ITS set out the requirements for how personal data should be handled and how confidential information should be exchanged between selling banks and prospective buyers. These rules are necessary because information needed for financial due diligence and valuation of NPLs may contain elements that are confidential under applicable law, internal rules or market practices. To complicate matters further, the precise information that is confidential may vary from portfolio to portfolio depending on e.g. the type of loan, the type of obligor, or the jurisdiction(s) involved. Selling banks will therefore need robust systems in place to ensure they can identify confidential information and that it is only shared through secure channels, and subject to appropriate confidentiality arrangements (e.g. sharing confidential information only with prospective buyers who have entered into appropriate non-disclosure agreements).

Taken together, the implications of the ITS are that EU banks originating loans after – or purchasing loans originated after – the ITS are adopted by the Commission and enter into force need to ensure that their systems can generate the information required by the templates. Additionally, they will need to consider whether their existing confidentiality agreements, and any other limitations or exclusions of liability, are adequate in the context of the new requirements. This, in turn, will depend heavily on the governing law and jurisdiction for resolving disputes elected under the relevant loan agreement.

Exemptions from the use of the data templates

EU banks who are finding compliance with the disclosure templates challenging have a range of options available to them. The ITS significantly expanded the range of exemptions available to EU banks selling portfolios of NPLs compared to the consultation draft. Notably, EU banks will not be required to complete the templates for:

(i). sales or transfers of loans that are not classified as non-performing exposures in accordance with Article 47a of Regulation (EU) 575/2013 ("**CRR**") by the selling bank at the time that the selling bank enters into a contract for the sale of the loan;

(ii). sales of NPLs as part of sales of branches, sales of business lines or sales of clients' portfolios which are not limited to NPLs and transfer of NPLs as part of an ongoing restructuring operation of the selling bank within insolvency, resolution or liquidation proceedings;

(iii). sales or transfers of NPLs pursuant to credit default swaps, total return swaps and other derivative contracts, contracts of insurance and in particular sub-participation contracts; or

(iv). sales or transfers of NPLs through securitisation where the EU Securitisation Regulation applies and the provisions of the related information is governed by the delegated and implementing regulations under that regulation (the "**securitisation exemption**").

The securitisation exemption

The securitisation exemption, however, might be of limited assistance to banks struggling with the disclosure requirements of the ITS, since the EU Securitisation Regulation currently requires NPL portfolios to do extremely detailed, templated loan-by-loan disclosure appropriate to the asset class of each underlying loan in addition to filling in a template of NPL-specific disclosure.

It is also worth noting that although the EBA's final draft ITS exempt NPL securitisations from the scope of the ITS and its data templates (along with some other transactions in accordance with proposed Article 2 of the ITS), that does not necessarily mean NPL securitisations escape the application of the other requirements of the NPL Directive. Although the EBA's Final Report accompanying the ITS states that the scope of the ITS and the NPL Directive should be the same, the ITS are not capable of amending the directive, which does not exempt securitisations from all its obligations.

This raises concerns and uncertainties about whether parties to an NPL securitisation remain in scope of the NPL Directive for the purposes of non-data template obligations, such as:

(i). the general obligation of the selling bank to disclose certain information to its host Member State pursuant to Article 15(2) of the NPL Directive, such as information on a creditor's rights under a loan agreement, detailed information about the credit purchaser and the type of borrower under the loan agreement;

(ii). the general credit purchasers' obligations, including the obligation to appoint a credit servicer and notify host Member States, the fair treatment of borrowers under NPLs or the appointment of an EU representative for non-EU credit purchasers; or

(iii). whether an EU bank or other entity performing credit servicing activities in relation to an NPL is subject to any of the duties imposed on credit servicers under the NPL Directive.

In addition, it is unclear whether the obligations of credit purchasers and credit servicers under the NPL Directive will apply where special purpose vehicles or other non-bank entities purchase NPLs before 30 December 2023. The Commission may address these concerns when it finally adopts the ITS or they may be clarified (ideally in a harmonised way) in the implementing measures of individual Member States.

NPL Securitisations and Recent Developments

Amendments to the EU Securitisation Regulation and the Capital Requirements Regulation as part of the "Capital Markets Recovery Package" in April 2021[3] have facilitated the securitisation of NPLs over the last year. These amendments defined a new category of NPL securitisations in respect of which the servicer may act as risk retainer, the size of the retention can be calculated by reference to the "net value" (taking the non-refundable purchase price discount into account) of the NPLs securitised and requirements with respect to verification of the credit-granting standards are adjusted. Taken together, these changes have made securitisation a much more viable exit strategy for NPL portfolios.

In addition, according to an empirical study of securitisations of non-performing loans from the ECB[4], the involvement of states in supporting NPL securitisations has created new NPL transaction markets.

This refers to government guarantee schemes such as the "Fondo di Garanzia sulla Cartolarizzazione delle Sofferenze" (or "GACS") scheme introduced in Italy in 2016 or the "Hercules Asset Protection Scheme" (or "HAPS") introduced in Greece in 2019. It seems likely that these schemes would mainly be used where the assets could not be securitised without the involvement of the state since they are comparatively costly to banks, in terms of capital cost, deeper discounts on the assets, and the coupon demanded by private mezzanine investors. Nonetheless, there is a market for these transactions, where more complex or problematic portfolios require the involvement of a government guarantee scheme for successful market placement.

Conclusion

Before the expected increase in NPL secondary market activity towards the end of the year, EU banks will need to consider the impact on documentation they use when selling NPLs, in particular whether their existing systems and confidentiality agreements are adequate in the context of the new requirements. Because most EU jurisdictions have yet to implement the NPL Directive, uncertainty remains around the form its detailed requirements will take, whether implementing laws will be harmonised on points that are currently ambiguous and, importantly, whether the stated objectives of the NPL Directive are likely to be achieved. Additionally, uncertainty still remains around the scope of exemptions under the ITS and the NPL Directive, which hopefully will be cleared up by the Commission's final ITS and Member States' implementing measures.

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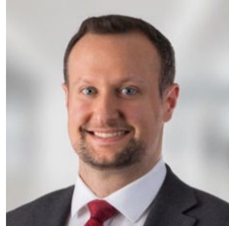
[3] Please refer to our March 2022 briefing entitled "*Non-Performing Loans: The Evolving Landscape*": https://www.cliffordchance.com/briefings/2022/04/non-performing-loans--the-evolving-landscape.html

[4] European Central Bank: An empirical study of securitisations of non-performing loans, No 292/May 2022.

CONTACTS

Chris Bates
Partner, London

T +44 20 7006 1041
E chris.bates@cliffordchance.com



Andrew Bryan
Knowledge Director, London

T +44 20 7006 2829
E andrew.bryan@cliffordchance.com

Lounia Czupper
Partner, Brussels

T +32 2 533 5987
E lounia.czupper@cliffordchance.com

Eduardo García
Partner, Madrid

T +34 91 590 9411
E eduardo.garcia@cliffordchance.com

Dr. Oliver Kronat
Partner, Frankfurt

T +49 69 7199 4575
E oliver.kronat@cliffordchance.com

Alberto Maero
Senior Associate, Milan

T +39 02 8063 4244
E alberto.maero@cliffordchance.com

Jesús Quesada
Counsel, Madrid

T +34 91 590 4174
E jesus.quesada@cliffordchance.com

Tanja Svetina
Partner, Milan

T +39 02 8063 4375
E tanja.svetina@cliffordchance.com

Antonia Walter
Senior Associate, Frankfurt

T +49 69 7199 1323
E antonia.walter@cliffordchance.com

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www.cliffordchance.com

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